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PRIVATE DEBT THEMES LEADING INTO A RECESSIONARY ENVIRONMENT

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Introduction

There's no doubt that the last three years have been a tumultuous time for global economies, and we have seen twists and turns which arguably nobody could have predicted. We find ourselves currently on the brink of recession, dealing with economies which have been pumped full of monetary and fiscal stimulus, uncomfortably high inflation and, in Australia at least, the most rapid interest rate increases in history.

Fortunately for private debt investors, private debt instruments are generally floating rate and do not carry interest rate duration exposure, so there is minimal need to take a directional view on interest rates when determining the appeal of the asset class (albeit impact on underlying borrower and therefore credit risk comes into play). As a result, private debt investors have recently benefited from the rising rate environment in the form of higher returns both from base rates, together with an adjustment to credit margins reflecting the current more challenging macroeconomic environment.

Additionally, in this uncertain environment, private debt investors primarily focus on the stability and resilience of borrower cashflows and ensuring there is an appropriate equity cushion within the capital structure. This is a different mindset to other asset class managers who will be primarily focused on equity valuations, which can be more volatile in times like these. So for appropriately structured debt where there is enough cushion to buffer cost and revenue pressures, the idea is that the borrower should be able to continue to meet its interest obligations. These factors can make this appealing in the current changing macro backdrop when investors can be drawn to less volatile asset classes such as private debt.

But how does this translate into private debt portfolios?

As part of assessing credit, we are closer to a longer recession than we have been for some time, so there is a heightened focus on downside analysis. This takes into account inflation, higher labour costs, supply chain challenges and higher base interest rates. We have to recognise there is a lag in the monetary policy adjustment phase and we are only part of the way through this adjustment and markets will take a while for changes to flow through. Consumers have built up surplus savings throughout the COVID period and those savings are now being utilised and are slowly diminishing, such that the direct effect of recent interest rate increases is taking a longer time, or having a prolonged lag effect of dampening consumer and business spending than might otherwise be expected. Given we will potentially see some additional interest rate rises over the remainder of 2023 , there certainly appears to be more downside to come. As such, we need to be more prudent as we assess historical cashflows with a view to predicting where the lag will hit prospective borrowers (if at all).

Higher inflation will likely lead to lower enterprise valuation multiples and thus likely lead to lower leverage multiples for debt for new deals. For existing deals, we will need to closely monitor the ongoing performance and business plans of our borrower management teams. We will be watching cost management in this higher inflation environment where wage pressure might continue to be a concern.

Focusing on cashflows

Rather than thinking purely about top-down sector exposure, cashflow lenders' attention should primarily focus on cashflow resilience of individual borrowers. In any sector you will have businesses that will perform well and have more stable and resilient cashflows, and ones that will not (leaders v. laggards). Any investment considered in the current environment will have an even higher degree of downside sensitivity testing (both in terms of interest rate and other macroeconomic factors) applied to ensure that over the life of the loan, the cashflows are resilient enough to be able to manage debt serviceability without major pressure.

Similarly, the focus is primarily on bottom-up fundamentals and deal-by-deal analysis. This is predominantly because most lenders are not actually in control of the deals that come to market, though we might pro-actively market to certain assets or sponsors. We are assessing opportunities that arise on a discrete basis, and decisions to invest are made using the knowledge we have and obtain as part of the due diligence process. Also, we may have access to additional expert knowledge and research housed within our firms (equities, fixed interest etc).

We can however look at certain sectors that have performed better over various cycles or stress points. Figure 1 below details the performance of certain sectors represented in the ASX200. Of course, this would include outperformers and underperformers in that sector – so it's a guide only – and again we would stress these types of insights inform our analysis at the time we are assessing a transaction, and relative to its own financial strength, or indeed if we are actively monitoring an investment in a certain sector.

The obvious outperformer right throughout these cycles is **healthcare** which is not unexpected, given the aging demographic of the population and the supportive government funding model which exists in Australia. Even within this sector, with a rise in out-of-pocket treatment expenses and general consumer strain, certain ancillary businesses may observe some declining demand moving forward for non-essential treatments. This demonstrates that taking a 'top down' view is secondary to understanding the nuances of individual borrower cashflows within their own market or sector dynamic.

Figure 1: ASX200 annual performance by sector

	FY2001	FY2002	FY2003	FY2004	FY2005	FY2006	FY2007	FY2008	FY2009	FY2010	FY2011	FY2012	FY2013	FY2014	FY2015	FY2016	FY2017	FY2018	FY2019	FY2020	FY2021	FY2022
Consumer discretionary	-19%	-34%	3%	27%	2%	3%	24%	-43%	-20%	10%	-5%	-10%	27%	13%	0%	16%	7%	11%	-1%	0%	43%	-23%
Consumer staples	29%	5%	-5%	7%	24%	12%	30%	-12%	-7%	11%	7%	-2%	25%	1%	-14%	-3%	12%	24%	1%	10%	5%	-2%
Communication services	-27%	-14%	-4%	15%	1%	-29%	30%	-11%	-20%	-6%	-9%	27%	30%	10%	20%	-6%	-26%	-35%	35%	-11%	27%	-9%
Energy	18%	-10%	-3%	41%	64%	32%	18%	35%	-26%	-4%	7%	-21%	5%	15%	-24%	-25%	6%	38%	-9%	-31%	7%	25%
Financials	21%	-1%	-7%	9%	16%	17%	19%	-35%	-19%	12%	3%	-4%	29%	14%	5%	-9%	12%	-4%	2%	-25%	36%	-11%
Healthcare	36%	-29%	-21%	26%	37%	24%	29%	0%	-3%	0%	5%	8%	41%	9%	27%	19%	13%	25%	11%	26%	5%	-11%
Information technology	-62%	-64%	-41%	50%	42%	28%	35%	-22%	1%	20%	-12%	-11%	37%	16%	-1%	-1%	14%	29%	18%	18%	39%	-39%
Industrials	20%	-4%	-16%	17%	33%	2%	35%	-37%	-34%	6%	11%	-8%	11%	12%	12%	15%	9%	3%	15%	-15%	8%	1%
Materials	16%	5%	-4%	33%	33%	46%	24%	18%	-35%	13%	17%	-30%	-10%	14%	-10%	-8%	22%	25%	15%	-5%	29%	-9%
Utilities	-7%	-2%	15%	8%	29%	16%	32%	-32%	-23%	2%	8%	10%	9%	12%	8%	18%	15%	-6%	0%	-7%	-23%	29%
A-REIT	6%	7%	4%	9%	10%	11%	19%	-40%	-47%	13%	0%	4%	17%	4%	16%	19%	-11%	7%	14%	-25%	28%	-15%

Source: Schroders, Bloomberg, September 2022. Past performance is not a guide to future performance and may not be repeated.

We can also highlight sectors that demonstrate stronger cashflow resilience (this includes both revenue generation and ability to manage inflationary cost pressures) in a recessionary or stagflationary environment.

The analysis in Figure 2 below confirms that consumer staples and healthcare are relatively the strongest performers during historic stagflationary environments. IT is clearly the sector that has historically performed the worst, so would require the closest attention, but we do particularly like **software as a service (SaaS)** businesses where software is a low-cost, integrated and highly embedded part of the data management systems of their clients – meaning sticky, long-dated contracts and cashflows.

In regards to **healthcare**, given Australia's universal healthcare model and Medicare system, combined with the Medicare surcharge supporting a high uptake of private health insurance, there is a broad-based bipartisan support for healthcare as a key policy pillar. With the Australian Labor Party dominant both federally and at the state level, it is our expectation that this support for the healthcare industry will continue for the medium term.

Figure 2: Annualised average sector return vs. MSCI World Index (since 1995), in %

Sector	Beta	Cyclical/defensive	Stagflation performance	Sector relevance for private equity
Consumer staples	0.7	Defensive	14.2	High
Healthcare	0.8	Defensive	6.7	High
Consumer discretionary	1.2	Cyclical	1.0	High
Industrials	1.2	Cyclical	-3.3	High
Communication Services	1.0	Neutral	-3.9	High
IT	1.1	Cyclical	-6.7	High

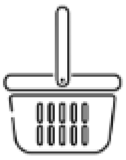
Source: Preqin, Schroders, Schroders Capital, 2022. Schroders Economics and Strategic Research Unit, from January 1995 to December 2021. Stagflation is calculated as the months where US CPI inflation is above its 10-year average and our Global business cycle indicator is in the slowdown phase. Capital IQ, Pitchbook. Public companies represent publicly traded healthcare companies traded on major exchanges in US, Canada, Europe and Asia. Past performance is not a guide to future performance and may not be repeated.

Additionally, **infrastructure**, or **infrastructure-like** assets have also shown resilience during downturns. Regulated infrastructure can recover increased costs in the form of adjusted or higher tariffs, and often benefit from inflation-linked contracts. Lightly regulated infrastructure (such as airports, for example) carry volume risk which might be impacted in a recessionary environment, however we can look back over many years to see how quickly initial traffic decline returns to normal. By and large, regulatory pricing regimes allow tariffs to be adjusted for recovery of costs even with somewhat prolonged challenges like those experienced during the pandemic. This sector also traditionally makes use of interest rate hedging to lock in interest rate risk between regulatory reset periods or other customer contractual periods, which is of particular benefit in the current rising interest rate environment.

With regards to **real estate**, we take comfort from our Schroders Capital Real Estate team's similar view about certain sectors of the **market** - specifically **industrial and logistics** and **regional shopping centres** which we see as being relatively resilient. With respect to the former, there is a severe lack of space in key urban markets, strong occupancy rates and rents adjusting to market rates. We are observing the larger players with strong multi-billion dollar pipelines and leasing pre-commitments underpinning development.

Neighbourhood shopping centres are the most liquid part of the retail focused real estate market. They are large in number and small in area, usually anchored by a supermarket and with the lowest proportion of discretionary retail. As a result, they outperformed during the pandemic when much of the rest of the market was under severe pressure and would be expected to perform similarly well in a recessionary environment.

Figure 3. Market situation and typical features of shopping centres across Australia

	Segment	Market situation	Typical features/issues
	CBD centres	Nearly 100 in total Oversupplied	• Concentrated in the eight state capitals • Under pressure from increased home working in cities • Near-term rebound plausible as office occupancy picks up
	Regional centres	About 80 in total Balanced	• Serve towns on big city fringes, or regional cities and their hinterlands • 5-6 anchor and 200-250 tenants in all; GLA of 50-90,000m^2 • Price range: $A 0.5-2.0bn for 100%
	Sub-regional centres	About 290 in total Balanced	• Serve smaller cities and rural towns; GLA of 20-50,000m2 • Often anchored by a discount department store and a supermarket • Price range: $A100-400mn for 100%
	Neighbourhood centres	About 1,129 in total Balanced	• Spread across larger and smaller cities; GLA of 20,000m2 • Usually anchored by a supermarket, low exposure to discretionary • Price range: $A20-100mn for 100%

Source: Schroders Capital (January 2023), JLL, Colliers, Shopping Centre Council of Australia (September 2022) for shopping centre numbers.

Where to be cautious?

If/when we enter a recession (especially a true recession versus a short-term ‘technical’ recession), discretionary spending will adjust, so sectors that are typically buoyant and reliant on discretionary spending such as tourism, certain parts of the retail sector and some areas of hospitality will intuitively suffer.

Again, being cashflow lenders, given the trajectory of interest rate rises and the laggard effects of this, any business that held higher leverage leading into 2022, had tight cashflow conversion, or was exposed to supply chain issues or currency fluctuations is a candidate for economic stress. The ability to deleverage via cutting costs (where variability of cost base becomes important), improving EBITDA margins and cashflow generation is critical.

We are cautious on the construction sector, or any sector directly/indirectly exposed to construction, because of the significant cashflow stresses that such businesses experience in higher inflationary times. Equally, lower unemployment is creating challenges around availability of trades staff.

We do however appreciate that where there is volatility there can also be opportunity to hold appropriately structured, well-priced debt to sector outperformers where downside risk is heavily scrutinised and mitigated.

Key themes in 2023 and beyond

Focus on climate change and sustainability will continue within the Private Debt markets (notwithstanding in temporary slowdown in momentum as firms both in Australia and globally tackle energy cost issues) so businesses which have not begun transitioning or have avoided addressing climate and/or biodiversity may find themselves harbouring a penalty of higher priced debt. Similarly, industries which have breached or are out of favour from a social and governance perspective, such as casinos, could also expect higher priced debt.

Services business in the construction and mining sectors traditionally struggle during recessions as contractors are often the first and easiest cost to cut, and we believe this cycle will be no different. Margins are likely to come under extreme pressure; we believe there will be latent assets and a prolonged distress cycle imminent.

We are also closely watching the response to the housing crisis. If a fiscal response addresses, for example, the social housing issue, this might create more activity in the construction and infrastructure sectors but negatively impact inflation in the short term. The Government's current discussions around changes to superannuation are potentially opening the door for super funds to invest in more social and national building projects, however even if the Government were able to achieve its aims, this would be a longer term change.

It is likely continued interest rate rises will create distress in the residential housing sector and banks will be put under pressure to assist mortgage holders to relieve stress rather than become mortgagee-in-possession. House price decline will have flow on impacts to the broader economy, with a contraction in home equity contributing to a slowdown.

We think the banks will continue to ration capital here, most likely in the commercial real estate space and this will create opportunity for non-bank real estate lenders to continue to benefit from this dislocation.

Positioning

Private Debt remains an extremely useful tool during times of uncertainty as, being a privately negotiated transaction, the terms and conditions of lending can adapt to ensure the underlying resilience of the investment (from the perspective of the investor). Each transaction is assessed on its relative merits, taking into account the prevailing environment and today we would see new deals being struck at lower leverage levels and paying higher premiums to those written prior to mid-2022.

We cannot deny the multitude of additional pressures being faced by borrowers in the current environment, however we can stress test for them. Ultimately, with a focus on diversification within portfolios, we'll be investing in best-of-breed names in sector classes.

The underlying strategic positioning of lending into this more uncertain environment is a combination of ensuring we are investing into better quality risk profiles and being compensated for that risk with higher spreads than perhaps were on offer during 2021 and into the first part of 2022. We'll be focused on maximising both the illiquidity and complexity premium over and above that available in public markets and expect that, in creating Private Debt portfolios for our clients, we will be actively utilising our structuring expertise as a safety measure to predict the best investments that may be able to withstand the challenging times ahead.

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