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EQuilibrium

Alternative credit: perspectives on opportunities and risks

HIGHLIGHTS

- With higher rates on offer in bond markets, institutional investors are revisiting traditional fixed income allocations, and yet alternative credit remains in demand, according to Nuveen's latest EQuilibrium survey.
- This paper explores three distinct areas that investors indicated they were pursuing: private credit, real estate debt and CLOs (collateralized loan obligations).
- Nuveen experts discuss what is driving demand in their sectors, and the opportunities and challenges for investors.

Even as traditional fixed income yields appear more attractive, institutional investors continue to explore alternative credit asset classes as a way to potentially improve the risk/return profile of their portfolios.

Until very recently, income-seeking investors were reaching out across the risk spectrum in their search for yield. However, rates are no longer languishing at ultra-low levels. U.S. interest rates[1] have moved steadily higher, from a post-pandemic low of 0.25% in March 2022 to 5.25% in May 2023. Having been anchored at zero for six years, European rates[2] began their ascent in July 2022, reaching 3.75% by May 2023. With rates at much more attractive levels, many investors are reassessing their approach and exposure to fixed income.

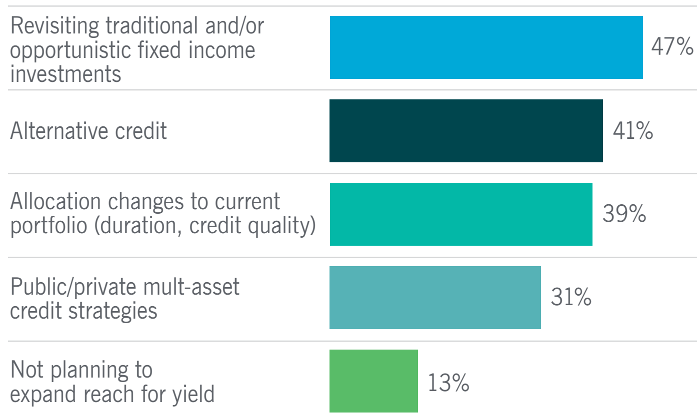
Nuveen's 2023 EQuilibrium survey found that over 80% of global institutional investors were planning to expand their reach for yield, and nearly half of those respondents were revisiting their traditional fixed income allocations. But exploring opportunities in traditional fixed income asset classes was not the only approach being pursued. Investing in alternative credit was selected as the next most popular course of action.

Alternative credit is difficult to define neatly. It comprises many different forms of debt and may include asset classes such as securitized/structured credit (including CLOs), direct/middle market lending, speciality finance, and other areas that typically do not fall within Core and Core Plus allocations.

The surveyed investors identified private credit (in the form of senior middle market debt), real estate debt and CLOs among the different forms of alternative credit in which they planned to invest.

Figure 1: Expanding reach for yield

In the next 12 months, how does your organization plan to expand its reach for yield? (n respondents = 800)



Source: Nuveen Equilibrium 2023 Survey

Randy Schwimmer

Co-head of Senior Lending, Churchill

PRIVATE CREDIT: AN INVESTOR-FRIENDLY ENVIRONMENT

Private credit: *Loans from non-bank lenders to companies with earnings (measured by EBITDA, earnings before interest, tax, debt and amortization) typically of $3 million to $100 million. Includes senior direct lending, junior (subordinated) debt, unitranche debt, and mezzanine debt.*

Q: How are higher rates affecting private credit?

With the Fed having hiked rates by over 500 basis points in little over a year, leveraged loan issuers are clearly being pressured by tighter borrowing costs. In turn, private equity owners are challenged to maintain their fund returns. Nevertheless we are in the most attractive direct lending environment we've seen in recent history.

Lower debt capacity means sponsors must invest more cash equity as a percent of total capital resulting in a larger cushion for lenders. Debt multiples are also down by a full turn of EBITDA. At the same time the benchmark rate jumped, loan spreads have widened - that produces the best spread per unit of leverage metric in memory.

Add to all this tighter and more numerous financial covenants and you have a very investor-friendly environment.

Q: What can investors expect from private credit in a recessionary environment?

Investors are often attracted to private credit for its stability during economic uncertainty. During the pandemic, for example, public markets showed significant volatility, while private debt did not. And of course senior middle market loans are floating rate so they can hedge against Fed hikes.

But higher interest rates are naturally concerning when leverage is too high. A recession would increase the risk of default.

Having invested successfully through the global financial crisis and other business cycles, the Churchill team understands how to construct

OPINION PIECE. PLEASE SEE IMPORTANT DISCLOSURES IN THE ENDNOTES.

an all-weather portfolio. Stress-testing each financing opportunity before we commit is critical. By selecting market leading businesses with high free cash flow characteristics in defensive sectors, we are prepared for a recession whether it happens or not.

Q: Where do you see the opportunities in current environment?

Our strategy is not opportunistic. We don't dip in and out of private debt depending on the prevailing macro winds. We partner with companies that are positioned for long-term success throughout the economic cycle.

They're typically less cyclical companies in health care, software, business services and technology, providing non-discretionary products or services with a large and reliable customer base. So they are well placed to service interest payments and pay back loans when rates go higher and market conditions are tough.

Even in today's challenging markets, these better businesses are still commanding near-record purchase price multiples of cash flow. With debt capacity down by at least a turn of EBITDA, private equity buyers need to come up with more cash equity. We have a thriving equity co-investment practice that has further stepped up its activity in this environment.

Q: Tell us about the outlook for your sector.

Private credit is now an essential source of financing to middle market companies (those with EBITDA between $10 to $100 million). Since the global financial crisis, many banks no longer participate in the direct lending business, and recent regional banking problems in the U.S. are only likely to reinforce that trend.

We partner with companies that are positioned for long-term success throughout the economic cycle.

Higher rates and demand-side challenges in the broadly syndicated market have shifted issuance to direct lenders. Churchill's investment activity reached a record high in 2022, surpassing 2021 (widely known as the most active year ever in the industry) when we invested $11 billion in over 375 transactions across senior lending, junior capital, equity co-investments and private equity fund commitments. As rates moderate longer-term, we expect some rebalancing to liquid loans for large-cap, rated issuers.

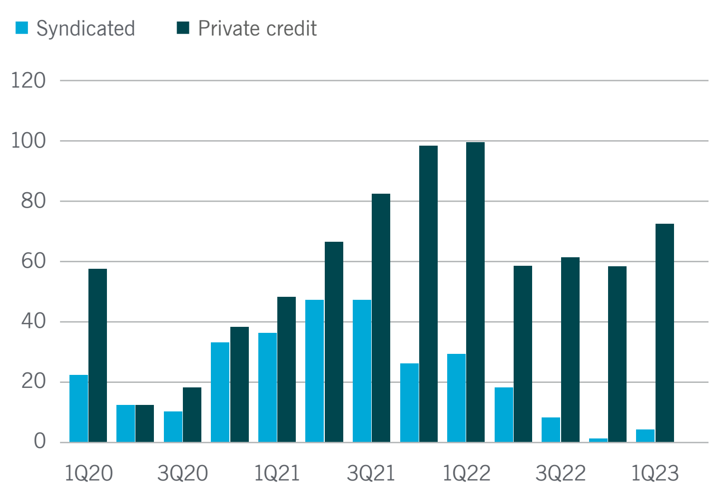
The sector is a growing source of attractive risk-adjusted returns and diversification for investors. Pricing is much more attractive with the increase in rates and wider spreads, leverage multiples are lower and financing terms for lenders have improved.

Q: You've discussed the macro risks. What other risks should investors be aware of, and how can they manage them?

Investors need to be sure that the opportunities match their risk and return expectations and are at the scale they require.

Partner with a private credit manager who can source a wide range of deals across sectors and deal types, and who has an established track record proving they can invest through an entire market cycle with a consistent philosophy and approach to unlocking value.

Figure 2: Count of LBOs financed in BSL vs private credit markets



Source: Pitchbook, LCD

OPINION PIECE. PLEASE SEE IMPORTANT DISCLOSURES IN THE ENDNOTES.

Jack Gay

Global Head of Commercial Real Estate Debt, Nuveen Real Estate

REAL ESTATE DEBT: ILLIQUIDITY IS OPPORTUNITY

Real estate debt: *Loans to fund the development or renovation of real estate properties, including multi-family housing, industrial or warehouse buildings, office buildings, retail space and other alternative forms of commercial real estate. It also includes Commercial Property Assessed Clean Energy (C-PACE) loans, a U.S. government policy-enabled financing mechanism for clean energy upgrades.*

Q: How are higher rates affecting real estate debt?

A year or so ago, spreads were tight everywhere, investors were chasing yield and liquidity was abundant. Today, yield is abundant in the market. We're doing unlevered whole loans at the same yields we were doing levered loans at more than a year ago. The challenge is illiquidity in the market, which is restricting deal flow. However, the environment to invest in new loans on improved credit metrics and pricing is better than we have seen for many years.

Q: Tell us more about liquidity risk. What can investors do about it?

Liquidity is the biggest issue facing the entire real estate market now. With the denominator effect impacting equity allocations, it is harder to raise capital in real estate. On the equity side, that means many open-end funds are experiencing redemption queues. On the credit side, loans that were made in a different environment of easier money, especially in the office space, may be more challenged. There's little to no liquidity to support maturing office loans. But the multifamily sector is supported by strong fundamentals, as is the industrial sector. So diversification can help manage risks.

The flipside to illiquidity is the opportunity to invest at very attractive yields and conservative loan terms.

Q: What can investors expect from real estate debt at different stages of the economic cycle?

Investors can insulate themselves from a weak market if their portfolio is focused on high quality real estate with strong sponsors and is well diversified and conservatively underwritten. The private nature of commercial mortgages allows for the lender and borrower to work through recessionary times by potentially modifying existing loan terms and maintaining a long-term approach to the investment. Additionally, the collateralized nature of the loans tends to lead to higher recovery rates in the event of a default.

The current economic cycle is dominated by asset values adjusting to a higher cost of capital. Some real estate sectors such as industrial and multifamily have well-balanced fundamentals. As a result, landlords can demand higher rents to offset the higher cost of capital driven in part by the higher risk-free rates. This may enable properties to retain value while also improving returns for debt investors as loan rates adjust up. As we move through the economic cycle buyers and sellers will come to terms with higher risk-free interest rates and liquidity will return to the property markets and debt capital will become more available.

> *The environment to invest in new loans on improved credit metrics and pricing is better than we have seen for many years.*

Q: Where do you see the top opportunities in current environment?

We think structured bridge loans can lead to attractive high yield debt opportunities for a few reasons. Spreads have increased, which means risk premiums are wider on debt investments today due to uncertainty around asset pricing. There's a supply and demand imbalance because of structural issues in credit markets and more regulatory pressures on banks, which has decreased lending capacity, as well as increased spreads. Structured bridge loans are generally floating rate, so they provide a hedge to inflation and an attractive yield in today's rising rate environment.

Q: Tell us about the outlook for your sector.

The medium- to long-term outlook is bright as structural issues in the U.S. banking sector may further increase opportunities for alternative lenders. Banks comprise close to half of commercial mortgage originations in any given year. So the prospect of a more restrictive regulatory environment should widen the opportunity set for private investors.

In the near term, there is uncertainty in the office sector as it adjusts to a secular shift in demand due to hybrid work arrangements. Other sectors like industrial and housing should be much more resilient through this economic downturn.

Q: How can investors manage risks in real estate debt when markets are volatile?

Investors may want to dial down risk in volatile times. Our view is let's take those sectors where we have conviction and that we understand, and let's knowingly take the illiquidity risk today and get paid for it.

Property values are more opaque as real estate investors adjust to a new rate environment. So, in the current more volatile markets, we are focused on the more resilient asset classes with simpler asset-level business plans.

Investors concerned about risk should work with asset managers who have scale and long-standing relationships with borrowers and bankers. These managers should be able to assess the risks and find good value opportunities through market inefficiencies. Additionally, managers with a broad platform that includes equity teams and research capabilities may lead to better outcomes due to enhanced information flow.

Himani Trivedi

Head of Structured Credit, Nuveen

CLOS: THE INTERSECTION OF BONDS, EQUITY AND ALTERNATIVES

CLOs: *Highly diversified pools of first lien, senior secured, broadly syndicated loans to large companies that are packaged into a securitization and actively managed within a non-mark-to-market structure.*

Q: CLOs are not well known. Can you tell us more about them and how they fit in an investor portfolio?

There are various ways for investors to access the CLO markets. Investors are able to customize their exposure based on their risk/return objectives. A more conservative investor looking for a fixed income replacement or complement may want a customized solution with more exposure to AAA and AA-rated tranches, while an investor looking for opportunistic fixed income or credit may choose a captive CLO equity fund, which may provide attractive cash-on-cash distributions as well as total return upside potential.

CLO equity allows investors to gain exposure to a highly diversified pool of broadly syndicated first lien loans using term-debt financing that is non-mark-to-market and locked in for the life of the CLO (WAL 5-7 years). In other words, you are getting exposure to the public markets in an alternative form. It sits at the intersection of fixed income, equity and alternatives. It pays quarterly interest and the underlying is bank loans, which looks like traditional fixed income, but the return potential and substantial upside link closer to alternative credit and equity asset classes.

We see most institutions adding CLOs to their credit allocation because they generally provide idiosyncratic returns. We have also seen investors allocate CLO equity to their alternatives bucket with other long-term, private market investments like private equity and debt. Some investors do this to diversify risk factor exposures, receive quarterly distributions - which is a nice diversifier to the J-curve for private markets investments - and provide a differentiated total return stream.

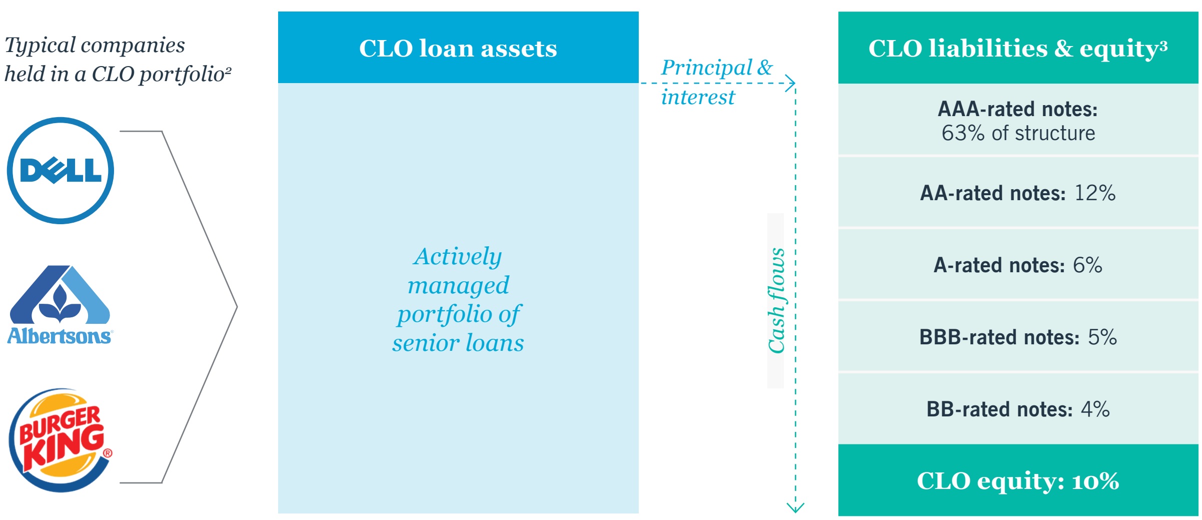
Q: How do CLOs perform in different market environments?

Historically, CLO equity was more a carry trade. An investor earned the difference between the spread of the liabilities and the spread of the underlying loan portfolio.

In today's more volatile market, the return profile is more dynamic. You may still earn the strong cash-on-cash distributions from the spread differential, but there is also a total return component when we are able to source high-quality assets at prices that trade at a discount to par.

Figure 3: CLOs explained

Collateralized loan obligations (CLO) are highly diversified, actively managed portfolios of first lien, senior secured loans with non-recourse, non-mark to market (MTM) leverage.[1]



- A CLO **borrows** money (liabilities), it **invests** in collateral (bank loan assets) and has **residual value** (equity).
- CLO equity investors **profit from any gains** on the CLO's loan positions as well as from the cash flow arbitrage, generated by the difference between the yield on the collateral (loans) and cost of financing for the liabilities.
- CLO equity investors can also **benefit from widening spreads**, since a CLO's liabilities are locked-in for the life of the CLO. If credit spreads widen, the CLO manager can re-invest the portfolio into higher spread assets, potentially boosting the CLO's cash flow arbitrage. However, this benefit can be offset by any defaults or other realized losses in the CLO portfolio.

1 Some broadly syndicated loan CLOs may include up to 10% second lien senior secured loans. CLOs have credit event triggers that may have MTM impacts.
2 References to specific company senior loans are illustrative and should not be construed as recommendations or investment advice.
3 Illustrative CLO structure.

Source: Nuveen

Q: Where do you see the opportunities in current environment?

We believe one compelling opportunity is in new CLO issuance and the ability to pick mispriced credits at cheaper prices. Not all CLO managers are capable of taking advantage of this environment. Managers that focus on active management, diversified revenue streams, fundamental credit picking and have a proactive investment philosophy will likely benefit the most.

I think this is also an environment that favors managers – like us – who focus on the more liquid portion of the broadly syndicated bank loan market and "print and sprint" deals (where CLO managers wait until after a CLO has priced before rapidly buying loans for the portfolio). We are currently focused on a conservative approach within our portfolios, investing in companies that we believe will be resilient and able to weather potential upcoming downturns. In fact, we generally pass on about 70% of new loan deals that come to the market due to our disciplined approach.

We are also very active in our portfolio management. Since we invest in the larger, more liquid part of the market, we are able to reallocate and rotate our portfolio as market conditions and our views change.

Q: Tell us about the outlook for your sector.

CLO markets are bouncing back rapidly and CLO liability demand from Japanese and European financial organizations has begun to recover. On the asset side, limited new loan issuance has been a headwind for CLO managers accumulating new portfolios, but continued outflows from retail loan mutual funds have served as a meaningful offset, fueling new CLO formation.

> *One compelling opportunity is in new CLO issuance and the ability to pick mispriced credits at cheaper prices.*

Q: What are the risks involved in CLOs and how can investors manage them?

Covenants, diversification guidelines and other bond-holder friendly structures provide embedded protection within CLOs. It is also important to look for managers with dry powder and captive equity who can be more selective when evaluating deals.

Investors need to remember that these investments are not point-in-time trades based on market conditions. They're not like other types of investments where you might be looking at asset class performance and try to pick of optimal entry and exit. It's really about aligning to your risk and return objectives and selecting a good partner. That will go a long way to manage the risks.

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For more information, visit nuveen.com.

Additional resources

10 considerations for building strategic allocations to alternative credit

EQuilibrium 2023 survey

Endnotes

1 As measured by the Federal Funds rate

2 As measured by ECB Main Refinancing Operations rate

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