2023 Outlook - Private Debt
New Landscape, New Opportunities

January 2023

Despite the changing macroeconomic backdrop we believe new opportunities are emerging for private lenders globally.

Kirsten Bode
Co-Head of Private Debt, Pan-Europe

Rafael Torres
Co-Head of Private Debt, Pan-Europe

Andrew Tan
Managing Director, Head of Asia Pacific Private Debt

Michael Smith
Co-Head of Private Debt, US

Capital at risk. The value of investments and the income from them may fall as well as rise and is not guaranteed. Investors may not get back the full amount invested.
Main Takeaways

- **Increased Return Potential** - Higher rates have increased the return potential for private debt
- **Ongoing Opportunities from Banks** - Private lenders are continuing to benefit from bank retrenchment
- **Investments in Defensive and Economically Resilient Sectors** - Recessionary risks are resulting in different opportunities and considerations in deal selectivity

Global credit markets have experienced a turbulent 2022. Russia’s invasion of Ukraine and a rapid rise in inflation and interest rates have altered the landscape for fixed income investors. Despite these challenges we believe private debt has held up well; perhaps the most obvious benefit being the higher return potential given the underlying loans are priced over base rates, which have risen in conjunction with interest rates.

Looking ahead, we believe private debt globally continues to offer investors opportunities, with different regions providing their own idiosyncrasies, of which dedicated providers can take advantage.

**Lower Middle Market Appears Insulated**

While there is a concern that higher rates may impact a borrower’s debt servicing capabilities, companies in the lower middle market (where our investments are focused) generally have lower leverage in comparison to their larger counterparts.

While we expect not all corporate budgets will be fulfilled, that does not necessarily translate into covenant pressure and liquidity issues. Relatively strong companies in this segment are generally more insulated from recessionary risk and could benefit nicely once there are signs of economic recovery.
Private Debt - Europe

Kirsten Bode  
Co-Head of Private Debt,  
Pan-Europe

Rafael Torres  
Co-Head of Private Debt,  
Pan-Europe

**Key Themes**

1. **Increased Opportunities from Bank Retrenchment**

For lenders in the lower middle market, banks are the main competitors. Yet a more cautious lending backdrop for banks on the back of recessionary fears, alongside the long-term underlying trend of broader bank retrenchment, is continuing to increase lending opportunities for private lenders. A lack of competition also means lenders can be increasingly selective and push through more conservative structures and better deal terms with regards to pricing.

2. **Illiquidity Premium Likely to Return in 2023**

The selloff in public market assets over the last twelve months has resulted in more attractive valuations. Although the illiquidity premium has shrunk recently, we believe this is likely to be a short-term theme. We expect the illiquidity premium within private debt will again become particularly attractive in 2023.

3. **Public Market Weakness Could Impact Demand for Private Debt in the Short Term**

Private debt has remained relatively insulated from recent extreme public market volatility. This lack of volatility and private debt’s floating rate nature should continue to attract investor interest. Short term however, we may witness the so-called ‘denominator effect’ where private debt assets now represent a larger percentage of total assets under management in investor portfolios. This may result in a temporary slowdown in allocations as some investors rebalance their portfolios in favour of other asset classes.
Private Debt - Asia Pacific

Andrew Tan
Managing Director, Head of
Asia Pacific Private Debt

Key Themes

1. Closure of Asia High Yield Bond Market
While global credit markets have felt the effects of rapidly rising rates and geopolitical issues, the Asia high yield bond market has had the additional turmoil of extreme turbulence in the Chinese property sector. As a result, it is extremely difficult for issuers to source funding in the public markets. Borrowers are instead turning to private lenders who can offer increased certainty of execution rather than play the lottery of uncertain technicals in publicly traded vehicles.

2. Banks Continue to Retreat
In a similar trend to Europe, banks are also stepping back from the lending market in Asia. Real estate forms a cornerstone of bank lending in the region. With concerns about an impending recession and a tighter monetary policy environment, borrowing costs have risen. This has increased the stress on bank real estate lending portfolios and impacted banks’ general lending appetite. We have witnessed less bank appetite for club or syndicated deals, as their ability to distribute these transactions has become more challenged and banks are withdrawing from acting as syndicators. This has resulted in private lenders becoming direct beneficiaries in both the primary and secondary markets.

3. Borrowers Choosing Debt over Equity
With corporate valuations falling in line with depreciating credit and equity markets, private equity financing is proving to be increasingly costly for lower mid-market borrowers. Instead, we have seen borrowers turn to the private debt markets which they view as a less expensive ‘bridge’ to equity. Private credit is also seen as a more efficient form of capital that is less dilutive than raising equity in the current market.
Private Debt - US

Michael Smith
Co-Head of Private Debt, US

Key Themes

1. Increasing Importance of Finance Network
   As interest rates have risen, so merger & acquisition activity has declined, making the competition for higher-quality companies even more intense than it has been historically. In such an environment, it is becoming increasingly important to have a strong network of financing partners to enable lenders to access and execute deals.

2. Growing Focus on Deal Selectivity
   We believe private debt is an all-weather asset class; it works in good times and bad. However, over the last decade or so the asset class has generally been through good or very good times, and we are now entering a period of macroeconomic uncertainty. This new environment is likely to favour private debt providers who have an intense focus on fundamental credit analysis and high deal selectivity. This will ensure that their portfolio companies can weather the storm. It will also benefit private lenders with deep expertise in certain deal types and the flexibility to do sponsored and sponsor less transactions. Such lenders will be able to potentially capture the best risk/reward opportunities during a time when competitors may pull back due to rising rates and higher defaults.

3. Contrarian Opportunities
   While a weaker economy may impact some sectors, Muzinich continue looking at opportunities in companies where we can invest capital at low leverage within strong businesses which have durable value propositions - companies with long-term secular trends unlikely to be impacted by an economic downturn. We are also looking for companies in certain pockets of the consumer discretionary sector that aim to offer resilient products with an inherent value proposition that can withstand fluctuations in economic cycles.
Conclusion - A Caveat of Caution

Overall, while the macroeconomic growth outlook remains uncertain, the demand for private debt - from both an investor and borrower perspective - is likely to continue. As public market valuations recover, renewed flows into the asset class are likely. Higher yields and a lack of mark-to-market volatility should again prove compelling for investors seeking portfolio diversification.

As we move into a new year and a potential recessionary environment, we see opportunities in companies in more defensive sectors as well as in those deemed more resilient to cyclical trends. However, across all regions, deal selectivity, structural and covenant protections, and prior experience in handling complexity will become increasingly key in navigating such an environment.

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