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Private Credit Insights: Every Problem Is an Opportunity in Disguise

Bank lending and deal flow on the decline, economic stress on the rise and some of the best yields our teams have seen. It's a surprisingly good time for private credit.

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Head of Private Fixed Income & Alternatives

Since taking on the newly created role of head of private credit and alternatives last year, I've spent much of my time on the road, face to face with current and prospective clients. Through a long, hot summer of meetings with pension plans, consultants, OCIO offices and insurance companies, many conversations focused on the perceived declines in deal flow, credit quality and regional bank lending. In many cases, these sources of concern are the very things creating opportunities for private credit investors who are able to pivot between adjacent markets:

- The turmoil in regional banking and subsequent liquidity crunch has **driven up yields for private credit investors,** in many cases into the low double digits.
- A slowdown in classic syndicated deal flow has masked **upticks in activity in direct, EM project finance, and non-US deals,** as well as interesting "fallen angel" opportunities.
- Commercial real estate's ongoing vulnerability to **credit deterioration** underscores the value of strategies that are less correlated to economic cycles and/or possess more flexible remits.

Corporate: Flexibility for the win

Subdued M&A activity and a perceived decline in syndicated/sponsor deals this year seem to be creating confusion among some clients about whether now is a good time to invest. This is where flexibility becomes important, because the deals are there for large platforms such as Voya. We benefit from a broad global sourcing funnel that includes direct deals, high yield project finance and private placements, and from our perspective there is still strong deal flow and significant opportunities.

Our **Enhanced Middle Market Credit (EMMC)** team has seen 86 middle market deals through end July, versus 92 deals over the same period last year. This is the advantage of the EMMC team's broader opportunity set, with 44% of its $2 billion in assets allocated to private placements and project finance deals sourced through its extensive network, with returns uncorrelated to the broader middle market. This ability to diversify has historically led the EMMC strategy to significantly outperform public high yield alternatives in all markets, with zero losses (Exhibit 1).

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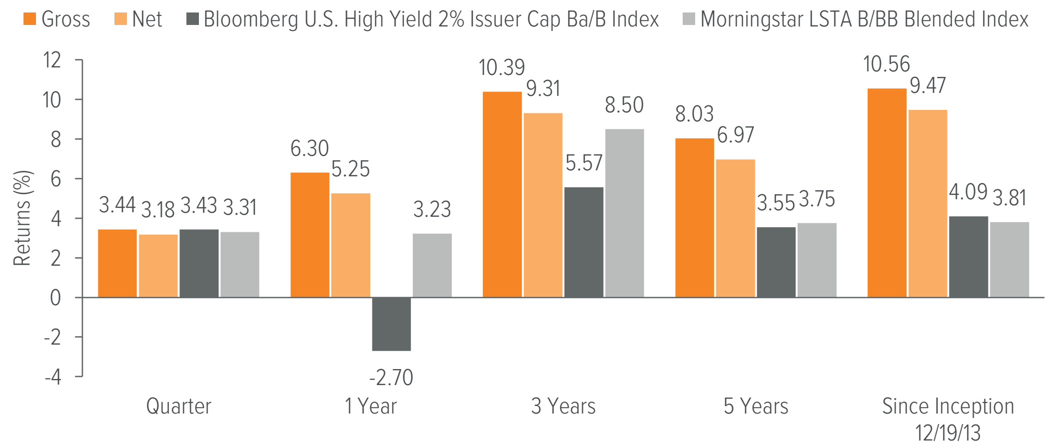
Exhibit 1. EMMC has consistently outperformed public alternatives



As of 3/31/2023. Source: Voya, Bloomberg, Morningstar.

We believe the current economic climate is likely to yield the best vintage of deals we've done in the EMMC program

For me, one of the primary appeals of Voya's EMMC platform in this market is how well the team is designed to handle times of economic stress. The EMMC team has over 15 years of experience in global workouts and restructurings They are well aware of how things go wrong, and structure their deals with an intense focus on capital preservation. Portfolio managers Gaurav Ahuja and Avi Tolani think the current economic climate could yield the best vintage of deals they've done in the EMMC program.

One especially promising area over the next couple years is the void that will be created by the pullback of regional banks from the loan market, coinciding with the huge maturity walls set to confront the loan market in 2024 and 2025. The team also anticipates opportunities in "fallen angel" deals, where non-client insurance companies become forced sellers of private bonds downgraded to below investment grade. Gaurav and Avi have had fantastic success in these situations previously, stepping in to provide liquidity and picking up those bonds in the secondary market.

The EMMC team has an impressive 10-year history trading on Voya's general account and, more recently, on behalf of 15 additional insurance companies. For the first time, we are opening this strategy to our broader alts platform clients to invest alongside us in an EMMC fund.

Infrastructure: It's easy being green

For non-investment grade private credit investors looking for strong risk-adjusted returns in a slowing economy, **Renewable Energy & Infrastructure Debt (REID)** could be an appealing allocation right now.

As REID portfolio co-manager Thomas Emmons says, "utilities don't go bankrupt when their sales go down; they go back to the regulators and get rate increases." The risk-adjusted return profile for debt investment within renewable energy is grounded in predictable revenue streams and the presence of hard assets, which are being deployed to generate revenues from investment-grade off-takers. Plus, the technology is proven.

The renewable energy business is generally less correlated to economic cycles. The environmental benefit is almost icing on the cake

That's a strong fundamental base for a debt investment, especially as the renewable energy industry tends to be less correlated to economic cycles. And because the sector's economic merits stand on their own, the environmental benefit is almost icing on the cake. It's easy being green when there's no sacrifice of return or credit standards.

Specifically now, REID is a beneficiary of this year's post-Silicon Valley Bank disruptions in the regional banking market, which have sucked some liquidity out of the financing market. In the past six months, lending from debt funds has become more cost competitive and therefore attractive to the project sponsors. This has created additional opportunity for achieving attractive returns. REID products also tend to be floating rate, which cuts return risk in a volatile interest rate environment.

Real Estate: Stepping into the void

Participating construction loans now offer the potential for real estate equity returns with debt risk based capital charges.

There are a few things happening in the real estate market that are being confused in headlines. Some concerns are valid, specifically office, where valuation declines will likely lead to actual losses for many lenders, and which will take time to fully resolve. But others are opportunities — for example, the ongoing turmoil in the banking sector (historically 25–30% of the commercial mortgage market) has caused a significant financing void. This is allowing our real estate managed account team to secure favorable terms for first mortgage debt in the form of participating construction loans.

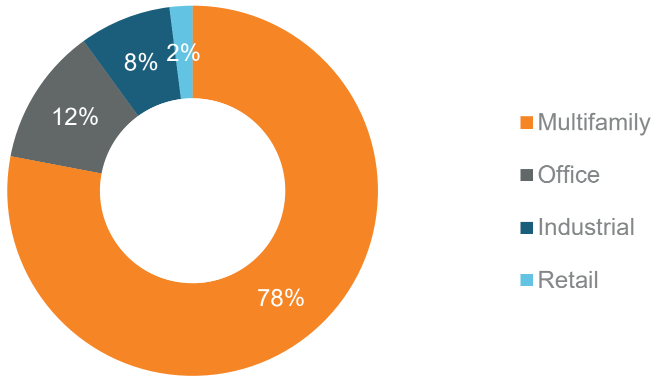
A participating construction loan is a flexible financial solution that effectively bridges the gap between the borrower's needs and the lender's risk management. Terms range from 2–3 years with extension options, providing a 7% annual coupon paid monthly through interest reserve from loan proceeds. In addition, participating construction loans allow lenders to partake in the cash flow of the property and the eventual sale (or refinance) of the property at loan maturity. The percentage participation is usually between 30–45% of the net operating income and the same share upon exit.

Historically, these first-lien construction loans had a relatively high loan-to-cost (LTC) ratio of 90% with a 75% loan-to-value (LTV) of the as-complete valuation. However, given the current market dislocation, lenders can source loans with much lower LTC and LTV ratios, creating a compelling investment opportunity. As a result, participating construction loans now offer the potential for real estate equity returns with debt risk based capital charges, which are significantly lower than real estate equity risk based capital charges. We see the most compelling loans in the industrial, multi-family, grocery-anchored retail, and self-storage sectors.

For the office sector, we expect the new world order of remote work to translate to higher vacancy rates and falling property values. While it is too early to say our office properties will escape unscathed, both our general account and our **Commercial Mortgage Lending Fund (CMLF)** have maintained a significant underweight to the space. In fact, according to a recent Barclays report on the commercial real estate holdings of insurance companies, our general account had the lowest exposure to office as a percentage of our total portfolio among our peers.[1] And the office properties we have exposure to tend to be less capital intensive than typical loans in the space.

[1]Source: Barclays Capital, CRE Risk Rising, February 2023.

Exhibit 2. Our exposure to the troubled office sector is minimal



We've always had a bias against office and hotels across all our investment strategies, due to their high capital requirements. Our head of real estate, Greg Michaud, jokes that in the 30 years he's been with Voya that the team has never been overweight office. That said, as with the construction space, our real estate team is ready to take advantage of opportunities created by other lenders walking away from loans in office. Typically, these situations are near-term maturities where the existing lender has not extended the loan, or a property acquisition that is moving forward with closing.

A team going from strength to strength

Lastly, I wanted to publicly congratulate our private credit team on the stunning growth and success of the platform over the past three years. In terms of assets under management for insurers, we are now officially the #3 private asset manager, the #1 private placement manager, the #2 real estate manager, and the #2 infrastructure debt manager.[2]

Please feel free to reach out to me or the team if you'd like to chat further about any of Voya's market-leading alternative strategies.

[2] Source: Clearwater Analytics' 2023 Insurance Investment Outsourcing Report, May 2023.

Principal risks: All investing involves risks of fluctuating prices and the uncertainties of rates of return and yield inherent in investing. Investments in commercial mortgages involve significant risks, which include certain consequences that may result from, among other factors, borrower defaults, fluctuations in interest rates, declines in real estate values, declines in local rental or occupancy rates, changing conditions in the mortgage market, and other exogenous economic variables.

All security transactions involve substantial risk of loss. The Strategy will invest in illiquid securities and derivatives and may employ a variety of investment techniques, such as using leverage and concentrating primarily in commercial mortgage sectors, each of which involves special investment and risk considerations.

High yield securities, or "junk bonds," are rated lower than investment grade bonds because there is a greater possibility that the issuer may be unable to make interest and principal payments on those securities. The Strategy may use derivatives, such as options and futures, which can be illiquid, may disproportionately increase losses, and may have a potentially large impact on performance. Foreign investing does pose special risks, including currency fluctuation, economic and political risks not found in investments that are solely domestic. Risks of foreign investing are generally intensified in emerging markets. As interest rates rise, bond prices may fall, reducing the value of the share price. Debt securities with longer durations tend to be more sensitive to interest rate changes. Other risks include, but are not limited to: credit risks, other investment companies' risks, price volatility risks, inability to sell securities risks and securities lending risks.

Criteria and assumptions: The performance track record presented here is considered hypothetical in nature and is based on an aggregation of individual loans held across certain external client mandates, as well as the proprietary insurance company affiliates of Voya Financial (the "General Account"). Inputs to the calculation include investment accounting records that serve as the basis for recording par values, interest accruals, and transactions for the pool of loans that meet the pre-defined scope of managed assets and the application of prices to the loan positions as per documented valuation policies and approved by the pricing and valuation committees of Voya Investment Management (available by request) to arrive at a daily return, which assumes a beginning of day weighting of capital flows. Daily returns are geometrically linked further to report performance over longer (quarterly, yearly and annualized) time periods. Returns labeled as "net of fees" will be calculated by deducting a monthly fee rate from the monthly return calculated above, using the highest fee rate applicable to the same or similar client type of the institution receiving the performance presentation.

Risks and limitations: Although inputs to the presented returns as described above are based on actual client investments into loans selected and managed by Voya Investment Management, they do not represent actual returns achieved by any particular client portfolio, given that formula inputs were based on loans carved out of multi-asset portfolios managed across the General Account and aggregated together with loans across a variety of external client mandates. Because Voya Investment Management does not manage cash and cash equivalents resulting from loan investments, all cash transactions (including cash flows from loan purchases, sales, maturities and interest payments) are treated as capital flows against the asset base and may not represent actual returns based on custodial records. While certain investment accounting inputs to the return calculation are assumed to be accurate, they are managed by internal personnel and are not based on externally audited investment accounting and valuation processes.

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