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Refinancing Risks on the Horizon?

A new market regime, economic cycles and megatrends all call for prudent yet active investment choices

December 2023

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Sailing across choppy waters

It’s been quite a year. 2023 saw one of the sharpest monetary tightening in recent times, major geopolitical tensions across continents, and uncertainties in the world’s two largest economies. Earlier in the year, a banking crisis erupted, leading to the closure of Silicon Valley Bank and Signature Bank in the United States (US) and the sale of Switzerland-based Credit Suisse. By year-end, however, prophecies of US recession had not quite materialised. Instead, talks of a ‘soft landing’ had increasingly taken its place. Corporates maintained their access to debt markets, notwithstanding the significant interest rate increases and the US banking liquidity crunch.

It may be too early to declare victory, though. The US Federal Reserve held interest rates steady in December 2023 indicating potential rate cuts in 2024, while ECB also kept rates unchanged, and the asset purchase programme continues to shrink at a predictable pace. That said, tangible risks remain in 2024, especially if the pace of policy easing is unable to match the momentum of slowing economies, as sticky inflation forces central banks to keep rates steady until end-2024.

In this backdrop, a combination of elevated interest rates, slowing global growth, and limited access to fresh capital could continue to constrain free cash flow for highly indebted companies. According to Fitch Ratings, corporate high yield (HY) and leveraged loan default rates are expected to rise in 2024 — with the former ranging 5.0-5.5% and leveraged loans ranging 3.5-4.0% — relative to 2023 levels, before declining in 2025.

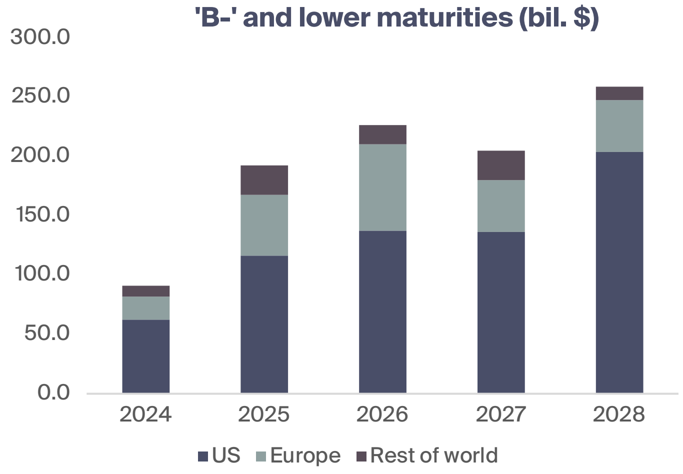
Structurally, we’re seeing a new regime marked by higher market volatility and much higher dispersion than in the pre-Covid era. 2024 will be more complex, dynamic, and uncertain than ever before. With this in mind, it is important that asset managers, owners and investors focus on fundamentals and diversification across risk factors, taking an active approach to asset allocation.

Refinancing risks on the horizon?

After years of loose money and low interest rates, the global balance sheet expanded much faster than GDP – with global debt reaching a record high of $307 trillion in June 2023 (Institute of International Finance).

In 2020 and 2021, favourable monetary conditions facilitated broad refinancing opportunities. Given the extended maturity profile of bonds, refinancing demand, which was subdued in 2023, is anticipated to surge significantly from 2025 onwards. Goldman Sachs estimates corporate debt maturity in the US alone to spike from $790bn in 2024 to $1.07 trillion in 2025. Simultaneously, the quantum of investment-grade corporate debt obligations in Europe is likely to surge to €193 billion ($206 billion) in 2025 and €200 billion in 2026 (Bloomberg).

U.S. accounts for most of the upcoming 'B-' and lower maturities (bil. $)



Source: S&P Global Ratings Research & Insights, data as of July 1, 2023

Though the maturities might seem distant, prudent corporate practices entail addressing maturities 1–1.5 years in advance. Consequently, 2024 assumes great significance for bonds maturing in 2025 and 2026. The tightening cycle of the US Federal Reserve has paused, yet marginal funding costs remain elevated and will remain so for some time. That, along with slow economic growth, might lead default rates to worsen. And as the market perceives the initial signals of rising defaults, investors are poised to shift towards investment-grade (IG) securities, concurrently divesting from HY bonds.

Key investor considerations

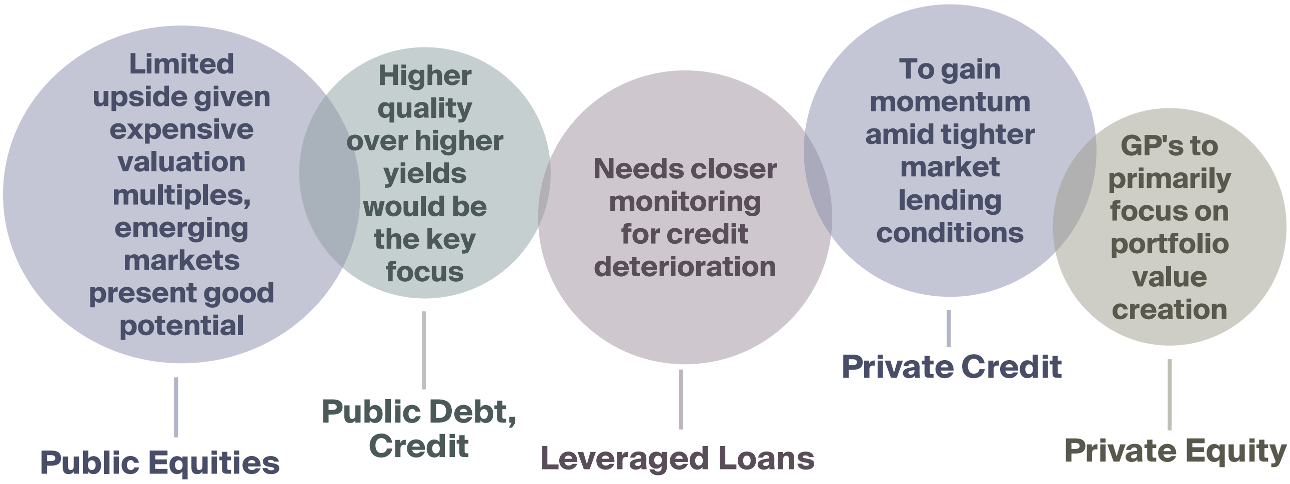
- The largest yield curve inversion since the 1980s has been in place from July 2022
- Over the past couple of years, yields on IG and HY bonds have jumped 350 bps and 475 bps, respectively
- Bond maturities (as a % of total outstanding bonds), which hit a trough in 2022, are projected to increase substantially from 2025 onwards, driving the need for refinancing.
- Considerable geopolitical risks are present. If the Russia-Ukraine conflict dominated the headlines last year, the Middle East conflict took centre stage this year. The conflict has impacted investor sentiment around markets in the Middle East, prompting a shift towards safer assets. The global equity markets, including US stock futures and Asian markets, declined in October 2023. While the economic impact of the conflict is uncertain, it could worsen if it spreads across the region, particularly to Iran, a significant oil producer.
- Global growth is projected to slow amid cooling but still-high inflation, especially in the US, Europe, and the UK. Meanwhile, China's growth will continue to be lukewarm driven by muted consumption, slow external demand, and challenges in the property sector.
- We see greater dispersion of returns unfolding across global markets. The 12-month average volatility was relatively muted in the context of geopolitical and macroeconomic risks.

Prudent choices in an imperfect world: an active investment approach remains vital

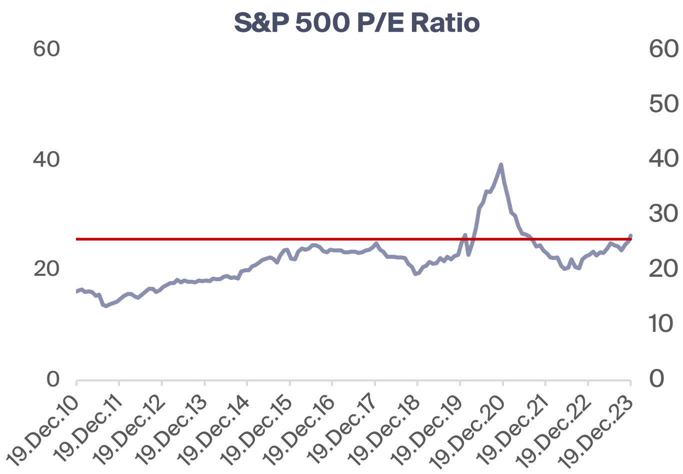
Active asset allocation backed by fundamental bottom-up security selection, and diversification across risk factors and markets (both public and private) would be the best approach in 2024.

- A new regime with higher volatility and dispersion creates the perfect opportunity for fundamental, bottom-up security selection strategies to succeed, and higher contribution to portfolio returns from alpha generation
- Further allocation across risk factors and markets, both public and private, will provide adequate diversification and potential for meaningful returns
- In private markets, the secondaries can further prove to be a valuable tool to adjust portfolio exposures, seeking exit options and evaluating new strategies such as real estate, infrastructure, and private credit

2024 outlook for fixed income and private debt remains positive



Public equities' performance could rise modestly in 2024: After strong gains in the first half of 2023, global equities posted a negative return in Q3. S&P 500 has returned an impressive 24% year-to-date through December 19. High valuations suggest future returns could be muted, as historical data shows that subsequent 10-year annualised returns at these levels have historically resulted in lower forward returns. Stripping out the top 10 names, S&P 500 multiples move from 19x 12-month forward earnings to a more reasonable 17x. For 2024, Goldman Sachs estimates that falling rates will push the S&P 500 2024 forward price to earnings multiple to 19.9x from its current 19.2x.



Source: Nasdaq

Looking ahead, equities seem to offer limited upside in 2024 with expensive valuation multiples. While emerging markets show potential for meaningful returns. The 12M trailing average monthly S&P 500 index dispersion has risen to 30% annualised – the highest since December 2009, (S&P Dow Jones Indices report, November 2023). Thus, indicating higher degree of uncertainty.

Public debt might command a larger share in portfolios in 2024: With financial stability risks remaining elevated, we believe asset managers would lean towards higher quality, rather than higher yields, in fixed income. Public debt allows for quick deployment, and the relatively high yields currently available in public markets have the potential to provide cushion against price volatility. The liquidity of public markets also creates the potential to shift quickly when market conditions change. The recent upside in the US 10-year bond yield is unlikely to sustain as interest rates hold steady and the Fed indicating rate cuts in 2024.

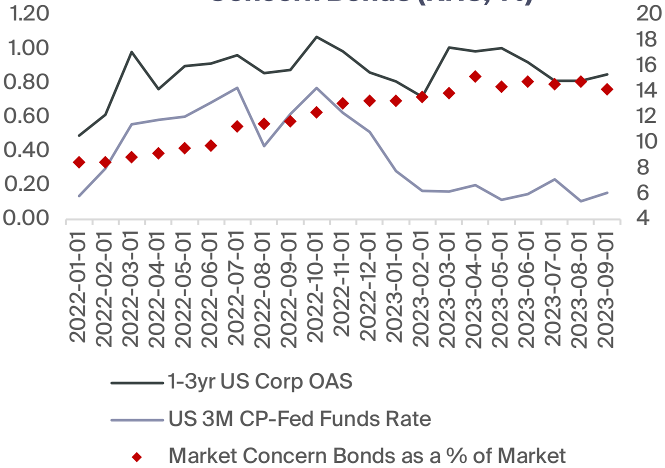
Nevertheless, the market remains watchful of the full impact of the 500 bps of rate increases since March 2022. We already see the signs through defaults that have picked up above historical averages. Under a base-case scenario, S&P Global Ratings now expects default rates in the U.S. and Europe to reach 5% and 3.75%, respectively.

Leveraged loan markets need closer monitoring: In the US, leveraged loan issuance fell 25.5% year-on-year from $849.5 billion during the first three quarters of 2022 to $632.8 billion during the same period in 2023. The drop mainly came from publicly traded loans relative to private loans. Similarly, leveraged loan issuance in Europe decreased 20.4% to €72.4 billion at end-September 2023, down from €90.9 billion at end-September 2022.

At the same time, default rates are rising. Rating activity indicates higher probability of downgrades making it imperative to keep a closer eye on this asset class. According to Morningstar LSTA US Leveraged Loan Index, the US leveraged loan default rate was at its highest since May 2021, bringing the November 2023 default rate to 1.48% (by amount) and 1.94% (by issuer count). Moreover, the global downgrade ratio increased to 54% in Q3 2023, vs. 52% in the previous quarter, indicating an increase in downgrades, as per the latest Global Credit Markets update by S&P Global.

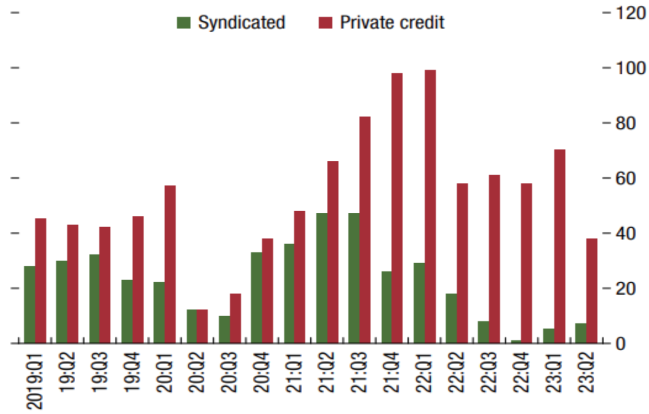
PE deal volumes to shrink: Global PE deal volume saw a 28% decline year-on-year in the first three quarters of 2023, reaching 6,304 deals. While the overall value decrease was steeper than the volume decline, reflecting stricter debt financing conditions, the market essentially returned to its pre-pandemic levels after a period of intense activity. The total value of $145.3 billion in the third quarter represented a 6% decrease from the second quarter's $154.4 billion, driven by a drop in deal count after holding steady in the first half of 2023. While the opportunity set for private large capital companies were limited, the small and middle market buyout space continues to see deal flow.

US Credit Spreads (LHS, %) and Market Concern Bonds (RHS, %)



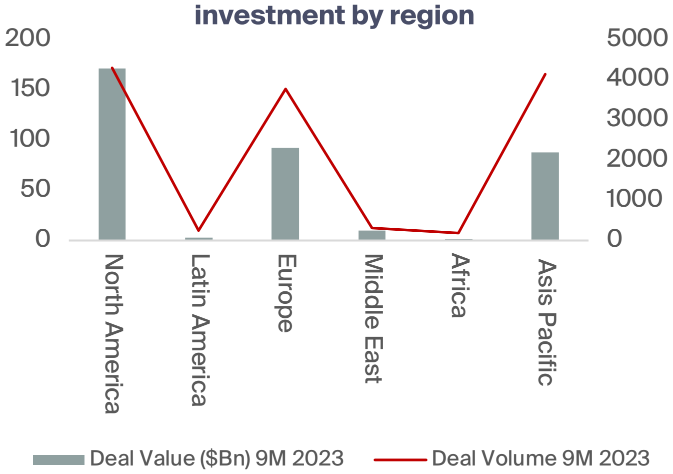
Source: FRED, Fitch Ratings U.S. High Yield Default Index.

US Leveraged Buyout Debt Financing



Source: IMF Global Financial Stability Report Oct 23

Private equity and venture capital investment by region



Source: S&P Capital IQ Pro, As of Oct 5, 2023

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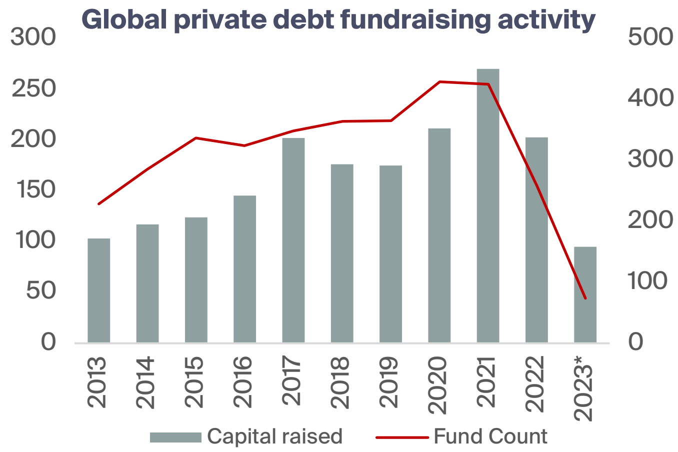
In 2024, strategic operational improvements will be the primary source for PE funds to unlock value in their portfolios. Higher rates correlate with lower asset prices, slowing the natural investment cycle and pushing GP's to contend with debt for underwriting new deals. Consequently, GPs will pursue creative solutions to raise additional funds in the coming year either through annex funds, sidecar vehicles or GP-led secondaries.

Private debt to sustain momentum: Private debt strategies continue to draw strong interest from institutional investors, with fundraising commitments at $94.9 billion in H1 2023 globally, considerably above $91.4 billion in H1 2022. With stronger historical seasonality in H2, we believe institutional commitments will exceed $200 billion for the fourth year in a row in 2023.

Positively, the asset class remains resilient in the face of economic and geopolitical headwinds – Proskauer's Q3 2023 Private Credit Default Index reported overall default rate at 1.41%, compared to 1.64% in Q2, and 2.15% in Q1.



Source: PitchBook Data, Inc. .*As of June 30, 2023

Private debt will continue to grow in 2024, as investors seek real time interest rate protection compared to investments like fixed rate bonds. Further challenging commercial lending conditions and an upcoming wave of bond maturities is expected to steer cash constrained borrowers to new arrangements to raise debt. Also, the growing secondaries market offers LPs a way around liquidity challenges and portfolio rebalancing.

Asset Class	Summary	Key Risks	View
Public Equities	Current markets are already priced in considering the high valuations and future earnings expectations, leaving little room for significant gains. At the same time emerging markets show potential for attractive absolute returns.	Higher volatility and dispersion.	– Neutral
Public Debt and Credit	Current market yields on public debt are relatively high, potentially providing a buffer against price volatility and inflation. However, this is not likely to last as central banks hold rates steady, further hinting at rate cuts in 2024. Overweight IG credit vs. HY	High debt servicing costs leading to additional credit deterioration.	↑ Positive

Leveraged Loans	Marked by economic challenges, and rising default rates are a primary concern. Lenders are favouring highly rated borrowers, demanding tighter covenants, and higher spreads.	Persistent economic weakness and upcoming maturities.	↓ **Negative**
Private Equity	Deal flow is expected to slow down as investors remain cautious of reductions in asset valuation and elongated investment cycle. Portfolio value creation through strategic operational improvements will be the primary focus for GPs.	Elevated inflationary pressures, persistent high cost of debt, and large corrections in public equity markets.	– **Neutral**
Private Debt	Private debt will continue to grow on the back of borrowers need for flexible capital or customized solutions. Structural shifts in the public financing markets have further helped the growth momentum.	High debt servicing costs during refinancing (especially for vintage deals underwritten in low interest rate environment).	↑ **Positive**