Private Credit

Q4 offered a slight reprieve to holders of risk assets, but the demand for uncorrelated, stable yield has not abated. Private credit continues to provide institutional investors with scalable opportunities – both as the need for non-dilutive capital continues to grow in the current macro backdrop, but also as the aperture that defines the asset class continues to widen. Some investors have sought to further diversify their private credit portfolios by considering the subset of niche strategies that seek to architect a credit-like return stream through acquiring outright an asset with a contractually obligated cashflow attached. This includes strategies such as royalty funds that invest in various music, film, entertainment, healthcare, or mining copyrights; transportation funds that focus on aircraft, shipping, or rail assets with leases attached; and commercial real estate funds that execute a triple net leasing strategy.

Investors be warned, these strategies – all characterized by contractual cash flows – are not created equal. And while they can offer significant diversification benefits to a broader private credit portfolio, each one poses a unique set of underlying risks that must be understood and dutifully investigated.

The most immediate risk stems from being the physical owner of an asset, as compared to a creditor with a priority claim to the value of an asset. The value of a cash flowing asset is related to the magnitude, stability, and duration of the cash flows. Music copyrights, for example, tend to exhibit highly stable asset values as music consumption trends have proven to be agnostic to the economic cycle for a variety of reasons. Compare this to the value of a shipping asset that is on charter to a logistics company, which has the propensity to be highly volatile.

Asset values may also be susceptible to macroeconomic shocks and tail risk events. An increase in corporate stress and distress due to inflation, rising interest rates, and recessionary concerns may decrease the credit worthiness of certain corporate tenants. When investing in triple net lease commercial real estate strategies, RockCreek has oriented its focus towards IG-rated tenants where default risk is inherently lower across an economic cycle.

Most of these credit-like real asset strategies are acquiring assets on a levered basis. In the current market environment, where interest rates (and the cost of debt financing) have risen significantly, it becomes more important that the type and structure of debt being used is appropriate and that adequate margins between asset yield and interest cost are maintained to preserve an investment return. Finally, it is also important to remember that an asset does not mature or benefit from any amortization features like a traditional credit instrument, resulting in additional liquidity risk. Investment monetization can only be achieved through the sale of the asset or through some other liquidity event such as a public market exit or "recapitalization" via a securitization.

When considering each of these risks, it is consistently true that credit-like real asset strategies are most appropriate for a private credit portfolio when they are characterized by highly stable asset values and cash flows. When understood and considered in the context of the prevailing macroeconomic environment, these risks provide an opportunity to generate outsized risk-adjusted returns, along with real diversification benefits. Moreover, in certain situations, being an owner of an asset affords the possibility of multiple expansion and income growth – participating in upside potential that may not exist with traditional private credit investments.

While we expect the demand for uncorrelated, stable yield to continue into 2023, we are also anticipating an improving market opportunity for distressed and special situations credit investments. Public credit markets generated a positive return, default volumes were benign, and inflation outlook turned arguably more favorable in the US during the fourth quarter. Although it may appear that the looming opportunity for distressed credit investors has evaporated, this may be presumptive as the year-to-date trends continue to indicate rising corporate fundamental headwinds, restrictive interest rates, increased distressed exchange activity, and idiosyncratic issues.

RockCreek continues to believe that Europe will present a superior opportunity to take advantage of market dislocations, stress, and distress. Moreover, the recent implementation of new bankruptcy regimes across continental Europe should add a layer of complexity to temper market competition.