Private Credit Insights: The Collateral Crunch (and How to Avoid It)

In a land of middle market mega-funds, exposure to low-collateral, private-equity-driven investments could become an issue—yet this is readily addressable with diversification into a higher-collateral specialist fund. Plus: smart ways to play commercial mortgage lending now.

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Key takeaways

- A sharp contraction in private equity liquidity, plus an oncoming maturity wall, could impact middle market lenders with large allocations to software, services and other low-collateral businesses.
- Strategies with a higher-collateral focus, low reliance on PE sponsors, and the ability to access project finance and private placement deals will increasingly provide important diversification from the herd.
- Despite the dismal office market and doom-laden headlines, select commercial mortgage lending strategies outperformed last year. This year has further upside potential.

A slowdown in PE exits could put low-collateral sponsor loans at greater risk.

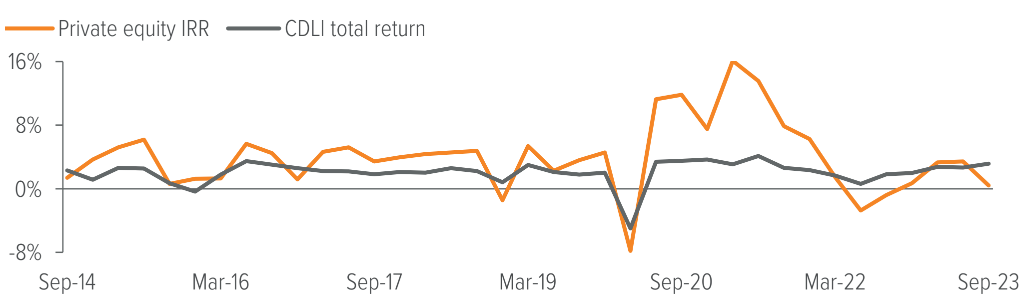
Middle market lending: Mega-funds' collateral conundrum

Bear with me as we go down a bit of a rabbit hole on an under-the-radar topic. It'll be worth it.

At first, the concentration of middle market private lending into a handful of mega-funds was a boon for investors, as it made market access extremely easy. But as this trend has continued, alpha has become harder to find. More worrisome, following the herd will provide little shelter if systemic issues in private equity bleed over to middle market mega-funds, thanks to their large proportion of low-collateral, PE-sponsored loans. Already, there's been correlation between PE and middle market returns (Exhibit 1).

Exhibit 1: Private equity and middle market direct lending returns, compared

Private equity quarterly IRR vs. Cliffwater Direct Lending Index quarterly total returns



As of 03/05/24. Source: Pitchbook, CDLI.

Over half of middle market loans will mature in the next three years.

The private equity dilemma

The ZIRP-era boom in private equity was due in large part to the availability of middle market lending: PE funds used middle market loans to fuel the burn of pre-product tech companies until they were bought out by a competitor or had a bigger investment round with a different syndicate of PE funds, either of which tended to happen within the three- to five-year duration of the loans.

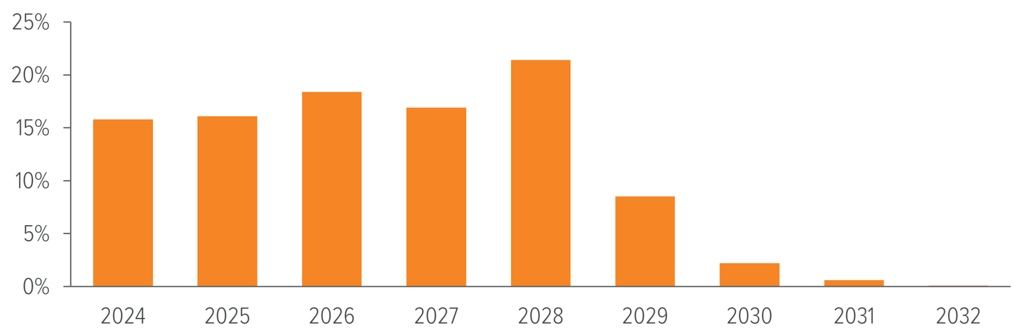
Lenders felt great because there was a (theoretically) experienced PE manager sponsoring the loan, who had a vested interest in growing the business and kept regular contact with company management. PE firms felt great because, hey, they just leveraged the heck out of their equity investment with cheap debt. Good business, while the party lasts.

PE firms were raking in so much capital that they found themselves sitting on a huge cash pile in 2020, which they felt pressured to invest—and many did, right at the top of the cycle. Health care startups. Blockchain companies. Services roll-ups. Then the exit pipeline came to a screeching halt. Now we're seeing a lot of low-liquidity PE funds gently pressuring investors to please consider their continuation fund.

All this sponsor loan activity in the past five years, plus the shorter durations in middle market, means there is a maturity wall hitting these loans: Each year from 2024 to 2028, 15-21% of the total outstanding loan base will mature (Exhibit 2). The 15.8% of loans maturing this year face the prospect of refinancing at the highest interest rates in two decades.

Exhibit 2: The middle market maturity wall

% of outstanding loan principal estimated to mature per year



As of 02/23/24. Source: Federal Reserve, Pitchbook.

Voya's EMMC has invested 56% of its funds in higher-collateral industries and 0% in software and tech.

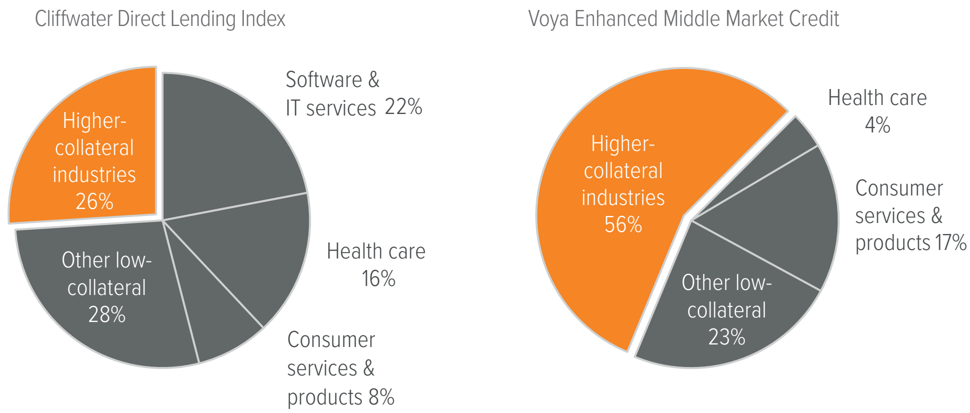
The average middle market fund is rife with low-collateral loans

At the same time, the middle market is facing a collateral crunch. All the covenants in the world won't help you when a software company goes under, because the only assets lenders can recover are some Aeron chairs and a foosball table. (I exaggerate, but not by much.)

Loans to low-collateral software and services businesses make up 74% of the $295 billion Cliffwater Direct Lending Index, with exposure to software and IT services alone clocking in at a staggering 22% (Exhibit 3).

By comparison, Voya's Enhanced Middle Market Credit (EMMC) strategy has, over its 10-year life, invested 0% of its money in software and tech. It also has a zero-loss record.

Exhibit 3: Loan collateralization: Voya's EMMC strategy vs. the market



As of 03/12/2024. Source: CDLI, Voya IM.

EMMC's top sectors are collateral heavy:

- Industrials
- Manufacturing
- Chemicals
- Aerospace & defense

EMMC invests in project finance and private placements, which are generally off-limits to mega-funds.

Why's that? Voya's middle market team started out as our private credit workout strategists. The EMMC team have lived through real credit cycles; while they've been running the EMMC strategy for Voya's general account and SMA clients for a decade, they've been in this market for 20 years.

The team runs our middle market strategy through a very choosy, credit-focused lens, which has led to industrials, manufacturing, chemicals and aerospace/defense standing as its top sectors.

(Voya's private credit desk, as a whole, has never been keen on tech, because it's an industry so regularly disrupted that a lot of promising companies get knocked out. The whole PE "invest in five, four fail, one's a 20-bagger" thing doesn't really work on the credit side. Likewise, health care has little control over whether a government policy will come along and put the kibosh on profits.)

Given current market technicals—specifically, the prevalence of low-collateral loans in many large middle market funds—bringing a higher-collateral strategy such as EMMC into the mix can both add alpha and potentially provide downside protection, while creating little to no overlap with existing investments.

Diversification, downside protection, deal flow: the EMMC advantages

EMMC plays well with core beta allocations to mega-funds because we rarely club up with them on deals. We're source agnostic, and we don't have to rely on maintaining relationships with PE sponsors to put money to work.

In fact, 44% of our historical capital deployment has been in deal types where the mega-funds simply don't—and in many cases can't—participate: project finance (9 deals) and private placement (19 deals, 5 of which are "fallen angels").

Project finance tends to have much higher collateral than traditional middle market lending, as the project is often structured as a JV or special purpose vehicle with separation from the rest of the company and a clear line to the assets.

This is an area where Voya shines, whether it's our commercial mortgage team doing construction loans, our REID team lending to build renewables infrastructure, our PCIG energy team financing liquefied natural gas facilities, or our EMMC team lending to Canadian cobalt mining.

Private placement is a distinct segment of the market with significant barriers to entry for normal funds. It's mostly insurers, and even then, access is skewed towards Tier 1 investors (such as Voya). But the borrowers do tend to be higher quality.

There are also "fallen angel" deals, in which private placements have lost their investment grade rating, causing a forced sale by IG-only investors. Fallen angels don't compose a huge sector—we estimate it at 1-5% of the $1 trillion IG private credit market in any given year. It's a good market, though, as borrowers are usually laser-focused on pulling their credit rating back up to investment grade. Then, as soon as they do, they prepay their middle market loans—causing a nice make-whole premium to kick in.

Commercial mortgage lending: Beyond the headlines

2023 was a year of outperformance for well-positioned CML portfolios. 2024 can be, too.

Our big theme with EMMC is that smart asset selection helps investors outperform, even in times of market turmoil. The same is true for commercial mortgage lending: While 2023 was considered an ugly year in real estate, some office-light strategies achieved near double-digit returns—at the same time that many office-heavy funds struggled.

Are you too late to get back into commercial real estate? No, and here's why:

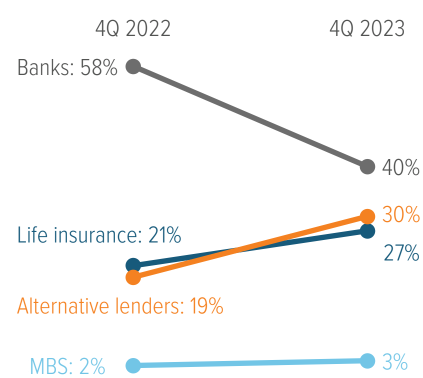
- **Market technicals:** Fewer banks lending, plus recovery from record-low commercial real estate (CRE) transaction levels in 2023, means more opportunities for well-positioned CML funds in 2024.
- **Improving macroeconomic conditions:** A soft landing and the likelihood of lower rates in 2024 support asset valuation and renewed transaction volumes across the sector.
- **Good fundamentals (really!):** Demand is driving industrial rents up, and a lack of supply is supporting retail rents. Although industrial is digesting a supply spike this year, both sectors have solid long-term outlooks.

Less competition from banks means better deals for lenders such as Voya

Let's hit each of these in turn. First, managers sitting on good assets with money to spend have an enriched opportunity set in 2024. The reason? Banks—usually a core competitor for commercial mortgage lending—are a lot less active. The regional lending landscape has constricted since the collapse of Silicon Valley Bank in March 2023. Even with CRE transactions dropping over 50% year on year in 2023, banks' share of loan originations fell significantly (Exhibit 4).

While there remains a decent amount of liquidity in the market, alternative lenders such as Voya are simply being offered more deals at better valuations. Take construction lending, a loan type now included in our open-end, commingled fund as well as in our separately managed accounts. A construction loan is a three-year, floating-rate financial solution that advances cash to merchant builders. Those three years give the borrower time to construct the property, lease the asset and exit through a sale or refinance. The loan typically comes with the option of two single-year extensions to allow additional leasing time, if needed.

Exhibit 4: What a difference a year makes: % of total CRE originations by lender type



As of 02/07/24. Source: CBRE Research.

In the current lower-liquidity market, Voya has been able to achieve coupons of 9.5% and a conservative loan to cost of 60–65%, with loans underwriting to a sub-60% loan to value upon completion.[1]

In short, it's a lender's market, and Voya has been able to leverage its three decades of relationships with mortgage bankers and borrowers to create one of the strongest and most attractive deal pipelines we've seen in a while.

A return to healthier transaction volumes is expected in 2024.

An improving economy and terminal rates help both valuations and transaction volume

Second, the Fed has likely reached terminal rates, and the economy is showing signs of a soft landing. That's positive for commercial real estate overall, and it may help both merchant builders and buyers/sellers come off the sidelines after sitting out peak rates. Because of this, we forecast that investment opportunities will increase versus 2023 for well-positioned funds.

Industrial and retail have different drivers but similarly attractive fundamentals.

Increasing rents and record-low vacancies, in this market? Believe it. And finally, fundamentals remain healthy in much of commercial real estate, especially in high-growth secondary markets—an area of focus for Voya. (Greg Michaud, our head of real estate, jokes that his favorite leading indicator is which destinations have the highest one-way U-Haul prices.)

Industrial and retail boast the strongest fundamentals, with opportunistic buys elsewhere

We've always liked industrial. Warehouses don't have to be brand new—or even pretty—and, as such, they're also not capital intensive. A tenant moves out? Great. Sweep it, and it's ready for a new tenant to move in. Industrial has been the most stable sector in recent times, with prices down only 5-15% since early 2022 and cap rates rising to around 6% in 2023 (Exhibit 5). The whole sector's also been boosted by the rise in last-mile logistics centers, which fit very well into older, lower-ceilinged industrial properties. Even parking lots are getting a facelift as "outdoor storage centers."

This year will see a lot of industrial construction completions (about a third of which are pre-leased), so we expect vacancies to tick up from 2023's 4% to around 6.5% as the new supply is absorbed. This leads us to be a little more cautious in 2024 as we keep an eye on rents. However, the construction pipeline is pretty short, and we could see undersupply returning as early as spring 2025, especially in smaller properties.

Select retail also looks good. Prices are down 5-20% off their peak, but vacancy is at 4.1%, which is the lowest on record. A lack of construction pipeline here should keep that vacancy number in the low to mid 4% range for the next few years. All of this is very cash flow positive.

Exhibit 5: Commercial real estate market snapshot

	Industrial	Retail	Multi-family	Office
Repricing since high	Down 5-15%	Down 5-20%	Down 10-30%	Down 30-75+%
Vacancy	6.50%	4.10%	7.60%	18.40%
Cap rate	5.75-6.25%	6.75-7.5%	5.75-6.25%	8-12%+
Rents	Increasing	Increasing	Decreasing	Decreasing
Net absorption	Decreasing	Flat	Increasing	Negative
New supply	High in 2024, then declining	Very low	High in 2024, especially A/A+, then declining	Very low

As of 03/12/24. Source: Voya IM estimates.

[1] As of 02/06/24. Source: "Construction Lending: Time to Dig In," Voya IM.

It's to the point that some owners look at store closures as opportunities to reprice, with competing bids from several different tenants—which seemed unthinkable a few short years ago. Average cap rates are rising, though underwriting and lending entry points remain attractive enough in our view to withstand any potential consumer weakness.

Strong, credit-focused asset selection can lead to outperformance, even in difficult markets.

Multi-family is likely to struggle in 2024, as a lot of new supply at the higher A/A+ end is pushing vacancy toward 10%. At the same time, expenses remain high, rent growth is decelerating, and rate caps on bridge deals are starting to expire.

Office remains a sector where our negligible exposure has stood us in good stead. The market has almost no liquidity, and prices are down 30-75%. The good news is that the major wave of foreclosures is in the past and cap rates have leveled off, helping to determine value. There is some opportunistic value here at the bottom, but we see no need to rush in—the recovery is likely to be slow and patchy, with a years-long reckoning over how remote work has changed businesses' real estate needs.

Conclusion: It's all about the assets

In some ways, middle market and commercial mortgage lending are two of the more misunderstood sectors in private and specialized fixed income right now.

In middle market, many investors conflate size and momentum with success in what has (so far) been a generally benign market environment that has lifted all funds. But equivalent or superior performance can be had, along with critical diversification from the herd, in a high-collateral strategy such as EMMC, which also offers increased downside protection in the event that cracks do appear in the middle market.

In commercial real estate, for many investors, turmoil in office and certain vintage, floating-rate multi-family deals has tarnished the entire CRE market. These investors stayed out of the asset class in 2023 and missed a year of outperformance from well-positioned, office-avoidant commercial mortgage lending strategies. Luckily, we expect 2024 to offer favorable opportunities as well, so there is still plenty of runway for clients to allocate back into the sector.

We would welcome the opportunity to discuss how our middle market, CML and other private credit strategies could add value to your portfolios.

Risks of investing

Middle market, private placement and project finance loans: The principal risks are generally those attributable to bond investing. Holdings are subject to market, issuer, credit, prepayment, extension and other risks, and their values may fluctuate. Market risk is the risk that securities may decline in value due to factors affecting the securities markets or particular industries. Issuer risk is the risk that the value of a security may decline for reasons specific to the issuer, such as changes in its financial condition.

Commercial mortgage lending: All investing involves risks of fluctuating prices and the uncertainties of rates of return and yield inherent in investing. Risks of real estate investing are similar to those associated with direct ownership of real estate, such as changes in real estate values and property taxes, interest rates, cash flow of underlying real estate assets, supply and demand, and the management skill and credit worthiness of the issuer. Concentration of investments in one or more real estate industries may result in greater volatility than a portfolio that is less concentrated. Other risks of include but are not limited to initial public offerings risks, convertible securities risks, manager risks, market trends risks, non-diversification risks, other investment companies risks, price volatility risks, Rule 144A securities risks, inability to sell securities risks and securities lending risks.

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