Michael Murphy: What rising rates mean for private credit investments

By Perpetual Asset Management
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Decades of low interest rates have tempted many investors into high-yield, low-quality investments. With rates now rising, it's time to health-check your portfolio, says Perpetual portfolio manager MICHAEL MURPHY

- High rates are exposing low-quality assets
- 'Mark to market' the key
- [Find out about Perpetual's credit and fixed income capabilities]

RISING interest rates are exposing hidden risks in private credit investments, making it important for investors to consider reallocating to higher-quality investments, argues Perpetual's Michael Murphy.

Murphy is a portfolio manager and senior high-yield analyst in Perpetual's credit and fixed income team.

Private credit has become an important asset class for Australian investors in recent years.

It has more than tripled in size in size since 2020 as changing regulations and stricter capital requirements lead banks to pull back on lending activities.

But the past decade of low interest rates and high liquidity has decreased the number of borrowers defaulting on their loans and encouraged investors to take on more risk in the search for returns, says Murphy.

"With interest rates expected to be higher for longer — and with a heightened risk of some kind of economic downturn — we think we're going to see a divergence between those who've been prudent in their risk management and those who haven't," says Murphy, who manages Perpetual Loan Fund.

Perpetual Loan Fund is a portfolio of private and syndicated loans that forms a crucial component of the ASX-listed Perpetual Credit Income Trust (ASX: PCI) and Perpetual's Pure Credit Alpha Fund.

"There's that old Buffett adage — when the tide goes out, you see who's swimming naked.

"The tide has been in for a very long time and now as it goes out, we're starting to see a bit more differentiation."

Private credit: a wide spectrum of risk

"Private credit is a bit of a catch-all term covering everything from property developer loans to corporate leveraged finance and ASX-listed companies," says Murphy.

That wide spectrum means a range of opportunities for investors, from high-quality companies with good financials and economic moats to the highly indebted with weak business operations and elevated risks.

"Our research shows the higher margin on offer from the riskier side of private credit generally doesn't provide compensation for the additional risk that you're taking on."

Risk in the private credit market manifests in multiple ways, not only through default.

More commonly, investors are faced with a restructuring event when a company may still be making an operating profit but is failing to generate enough earnings to service its debt.

This leads to negotiations to restructure the debt into a more sustainable capital structure, says Murphy. Typically, debt is reduced and borrowers may receive equity in the company.

“You'll often hear managers say ‘we've had no defaults’ — but it is reasonably rare for a company to get to that stage.”

Marking to market

In Australia, private credit is generally not traded on a secondary market, unlike the US where there is a secondary market for syndicated loans.

Murphy says this can present a challenge to investors seeking to understand valuations.

“Some managers just mark for par unless it’s impaired. Others will mark to market,” says Murphy.

A ‘mark to market’ valuation aims to provide an appraisal of an asset based on current market conditions. ‘Mark to par’ refers to the practice of valuing an asset at its face value.

“This is important, especially if you've got an open-ended fund,” says Murphy. “You’re funding redemptions at the market value, so you don't want to get to the stage where investors are redeeming their units based on a value for those loans that isn’t the true market value.”

Sector example: healthcare

One popular sector that could cause headaches for investors is healthcare.

Despite seemingly strong fundamentals like an aging population and increasing demand, the health sector faces numerous challenges that many have overlooked, says Murphy.

This includes increasingly competitive markets, rising wages costs, a tightening of payments from the insurers who fund the sector and competition for specialist doctors.

“Healthcare represents a large portion of the market for private credit — and there is strong demand from lenders who are willing to provide high levels of debt relatively cheaply.

“But our research shows there are headwinds that are under-appreciated.

“If you do start to face those headwinds, it can turn quite quickly in terms of them then struggling to repay those debts.”

Seek out quality

Murphy says investors should adjust their portfolios to the new circumstances by seeking out higher-quality assets.

“Funds focusing on the lower-quality end of the spectrum — and offering mid- teen returns — almost always struggle to meet that objective. There are not many situations in Australia that meet that return hurdle.

“But as rates rise and spreads widen, even high-quality businesses are now delivering high single digit to low teen returns.

“At that end of the spectrum you can earn attractive returns even against equities without taking on too much risk.

“You have security over the business — so you're contracted to be paid before everyone else.”

Murphy says investors should seek out managers focused on the quality end of the market, with a mark-to-market policy for their funds and the agility to move in and out of the market as risk reward profiles change.

“Having that flexibility and discipline to stay out of the market when the risk-reward isn’t there is a real advantage.

“If you were a fund that was really expanding aggressively in 2021, that means you're going to have a significant part of your book that, on average, offers less quality in terms of being high risk and generally low return.”

About Michael Murphy and Perpetual’s Credit and Fixed Income team

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Michael manages Perpetual Loan Fund – a portfolio of private and syndicated loans that forms a crucial component of the ASX-listed Perpetual Credit Income Trust (ASX: PCI) and Perpetual’s Pure Credit Alpha Fund.

Perpetual offers a range of cash, credit and fixed-income solutions.

Our credit and fixed income team are specialists in investing in quality debt.

They take a highly active approach to buying and selling credit and fixed income securities and invest extensively across industries, maturities and the capital structure.

Learn more about Perpetual’s Credit and Fixed Income capabilities

Questions? Contact a Perpetual account manager

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