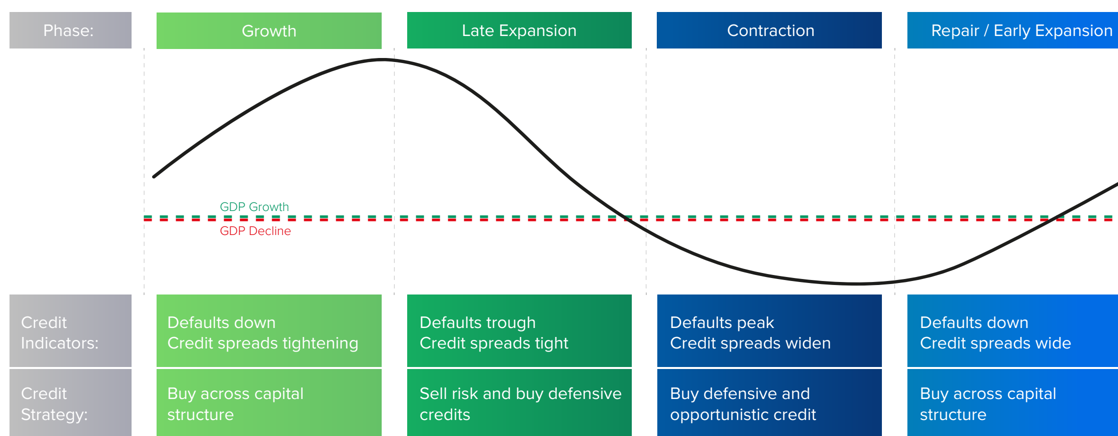
DIGITALBRIDGE

# Preparing for a Contraction in the Credit Cycle

As recession risk grows, yields increase and private credit investors should position their portfolio to benefit from the contraction stage of the credit cycle. Although it is nearly impossible to predict the exact timing of a market peak or trough, key credit indicators show that the market is transitioning from a "late expansion" to a "contraction" stage. While public securities tend to decline in an uncertain or deteriorating market, a proactive private credit strategy offers investors the opportunity to deploy into the contraction phase at higher yields and more conservative structures – positioning their portfolios to outperform across the entire credit cycle. As detailed in our inaugural white paper, exposure to key growth sectors, notably digital infrastructure, is underrepresented in most credit portfolios. This under-allocation, bolstered by the growth economy's strong performance in periods of dislocation (our second white paper), implies the current environment is ideal for investors to build positions in modern, growth-driven sectors like digital infrastructure.

**The Credit Cycle**




## Identifying our Current Position in the Credit Cycle

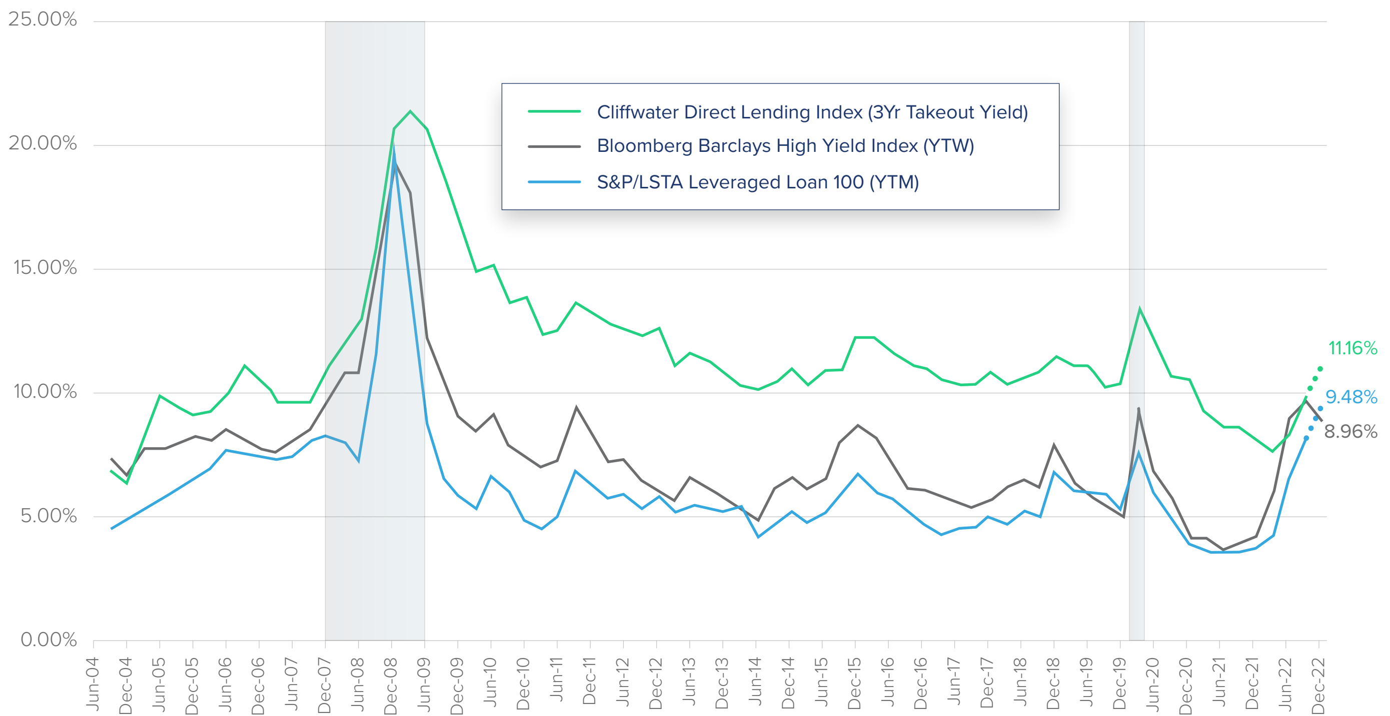
Overall credit markets, as defined by corporate bonds and loans, remain in the Late Expansion phase while higher risk credit, defined by high yield bonds, syndicated loans and private credit, are already offering yields indicative of a Contraction. Low interest rates and abundant liquidity powered one of the longest bull market runs in history, but consequent inflation (induced by COVID, supply chain disruptions, commodity prices, Ukraine conflict) and subsequent rate hikes by the Fed have significantly raised risks of an economic contraction. 77% of fund managers say a recession is likely in 2023, and 92% expect stagflation.[1] The exact timing and severity of the cycle is yet to be known and will depend heavily on the Fed's actions and ability to tame inflation.

Credit market fundamentals mirror the economic trends. High market volatility, fueled by a selloff in stocks and bonds, has caused the banks to tighten lending standards. This tightening has only been exacerbated following multi-billion-dollar losses on leveraged loan syndications (e.g., Citrix, Twitter, Nielsen) by the major underwriting banks. In 2022, U.S. institutional leveraged loan issuance declined -63% versus prior year and was -41% below the 10-year average, evidencing a drastically lower appetite for risk given the uncertain economic environment.[2] The share of U.S. distressed loans (loans trading below 80% of par) finished December 2022 at a level eight times higher than prior year. To further establish our current position in the credit cycle we examine two key credit indicators – leveraged loan default rates and credit yields – both of which make the case for an end to the Late Expansion phase.

1) The **U.S. leveraged loan LTM default rate** bottomed in April 2022 at 0.18% before increasing to 0.72% in December 2022.[3] However, the default rate remains well below the 2.3% 20-year average, suggesting we are still early in the transition period. S&P's 2023 default rate forecast is 3.75%, with a pessimistic scenario of 6.0%, as higher debt funding costs will raise insolvency and credit losses.[4]

2) **Rising credit yields** have historically preceded a recession. In the early stages of the Great Recession and briefly in 2020, direct lending, high yield bonds and leveraged loans yields spiked due to economic slowdown, increasing defaults and tightening credit conditions. As of year-end 2022, Fed tightening has caused high yield bond and leveraged loan yields to more than double to ~9% following lows in mid-2021, while private credit yields have grown to ~11%+.

Direct Lending, High Yield Bond & Leveraged Loan Yield Comparisons[5]




## How to Prepare for a Contraction

The banks' incredible retreat during 2022 creates a window of opportunity for private credit to fill the gap and accelerate a trend that started in the wake of Dodd-Frank's increased banking regulation. Aided by the elimination of syndication risk, U.S. direct lending AUM has grown from $40B in 2010 to $530B+ in 2021, a 24% CAGR.[6] Increasingly, banks and high yield bonds are being bypassed entirely in favor of exclusive funding from direct lenders (e.g., Thoma Bravo's leveraged buyout of Anaplan in June 2022). **In the Q3 2022 middle market, estimated direct lending deal volumes exceeded syndicated loans and high-yield bond deals combined.[7] By leveraging this momentum in private credit, we believe the following takeaways will allow credit investors to position themselves for a transition to a contractionary environment:**

## Preparing a Credit Portfolio

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| **We expect the private credit market will offer a more attractive risk-return profile than high yield bonds** | • Private credit predominately features floating rates, which mitigates interest rate risk, while bonds have fixed interest rates and longer maturities, resulting in higher duration risk and price sensitivity to fluctuating rates<br>• Since private credit loans are collateralized and higher in the capital stack than bonds, and typically have additional downside protection through covenants, private credit has historically had superior default and recovery rates than high yield bonds<br>o Default rates: In the last 20 years, U.S. loans have averaged a default rate of 3.05% vs. 4.36% for HY bonds, a +1.31% average outperformance[8]<br>o Recovery rates: Average U.S. first lien loans recovery has been 62% in the past five years, exceeding average U.S. senior unsecured bond recovery of 41% by +21%[9]<br>• Private credit has a low correlation to other major asset classes, which can serve as a key differentiator during potential shifting stages in the credit cycle |
| **Take advantage of opportunistic credit** | • Companies that have solid fundamentals but are seeking precious investor capital in a contractionary environment may be willing to accept higher yields<br>• Equity-like yield can potentially be achieved with lower volatility and higher risk-adjusted returns by taking advantage of higher base rates |
| **Choose private credit funds that have ample dry powder to deploy in today's market** | • A contractionary market with declining liquidity, driven by tightening Fed policy and heightened lending standards at banks, offers considerable opportunity for private credit funds with ample dry powder to deploy in a yield-rich environment with enhanced lender protections (tighter documents, lower leverage)<br>• Private credit offers a compelling opportunity to deploy capital for equity-like returns with downside protection from inflation and increased defaults. Capital markets constraints dramatically reduce new leveraged loan, high yield bond and equity M&A investment opportunities in value environments. The demand for private credit offers value investors the opportunity to deploy capital with equity-like returns and multiples on invested capital |
| **Invest in the "growth economy" through Digital Credit to mitigate downside risk** | • "Growth economy" loan prices have historically outperformed "old economy" prices by 1.48 points[10] (see our second white paper, "Financing the Growth Economy through Digital Credit Part II")<br>• Digital Infrastructure (e.g., data centers, fiber, cell towers) is the backbone of the growth economy and comprises real assets with recurring revenue underpinned by contracted cash flow, high barriers to entry and high switching costs. Significant digital demand (via 5G, cloud apps, AI, Internet of Things), combined with insufficient infrastructure supply, requires substantive investment and propels this growing yet defensive and recession-resilient asset class<br>• Digital Credit offers investors direct access to the growth economy by combining private credit with digital infrastructure sector expertise, allowing the strategy to target attractive risk-adjusted returns (see our first white paper, "Financing the Growth Economy through Digital Credit Part I") |

## Conclusion

While an upcoming contraction phase is the present focus, we believe private credit provides investors the ability to successfully navigate all four climates of the credit cycle and maximize investment returns. Private credit offers collateral and inflation protection while capturing the yield premium; since 2004, U.S. direct lending yield has averaged a ~400bps premium to high yield bonds and a ~540bps premium to leveraged loans.[5] Digital Credit in particular focuses on financing mission-critical "growth economy" assets that are well-positioned for tumultuous macroeconomic conditions that likely lie ahead.

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### Footnotes:

1. Bank of America Fund Manager Survey, November 2022.

2. S&P Leveraged Commentary & Data for Leveraged Loans, December 2022.

3. S&P Leveraged Commentary & Data for Leveraged Loans: default rate by total amount outstanding, December 2022.

4. S&P Global Ratings, November 2022.

5. Bloomberg Barclays High Yield Index as of 12/31/22. Cliffwater Direct Lending Index and S&P/LSTA Leveraged Loan 100 as of 9/30/22; DigitalBridge estimated 12/31/22 by adding the 133bps SOFR movement from 9/30/22 publication to 12/31/22, which were not fully reflected in the 9/30/22 yield amounts.

6. Preqin, as of October 2022.

7. S&P Leveraged Commentary & Data for Leveraged Loans, Middle Market Review, Third Quarter 2022.

8. Moody's Default Report as of December 2022.

9. Moody's Default Report as of December 2022.

10. S&P Leveraged Commentary & Data for Leveraged Loans, S&P 500 for Equities, as of December 31, 2022. Growth Economy sectors include Communications Services, Financials, Health Care and Information Technology. Old Economy sectors include Consumer Discretionary, Consumer Staples, Energy, Industrials, Materials, Real Estate and Utilities.

## About DigitalBridge

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