PRIVATE CAPITAL

Harnessing the Potential of Private Structured Credit

A Focus on Insurance Portfolios

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Executive Summary:

1. Private Structured Credit (PSC) presents a specific investment avenue, seeking to offer insurance investors yield pick-up vs public bonds, capital efficiency, risk mitigation via covenant protection, and sector diversification.
2. Insurance companies in particular may benefit from PSC due to the predominance of investment-grade assets and the potential for attractive spread per unit of Risk-Based Capital.
3. MetLife Investment Management (MIM) adopts a measured approach to PSC, utilizing its deep bench of credit analysts and focusing on strong transaction structures to help mitigate risks.

MetLife Investment Management

Introduction

PSC presents a less-trodden path in the universe of potential investments, characterized by securities underpinned by a diverse pool of assets. As the financial landscape evolves rapidly, and with insurance companies facing their own particular set of regulatory and market challenges, understanding and leveraging the potential of PSC becomes even more critical. At MIM, we're committed to guiding our investors through this complex territory with a balanced approach.

This paper offers an in-depth yet simple exploration of the world of PSC, its differentiation from public Asset-Backed Securities (ABS), its appeal for insurance companies, potential risks and rewards. We delve into our approach at MIM, which prioritizes disciplined underwriting and strong structures that help to protect our investors. We hope to provide insurance companies with insights into how PSC can serve as a strategic component of their portfolio.

Quick Overview of PSC

PSC is an investment strategy that potentially provides portfolio diversification in predominantly investment grade assets at spreads meaningfully above public corporate bond indices. For insurance investors in particular, PSC can offer capital efficient assets with attractive spread per unit of Risk-Based Capital.

PSC transactions are supported by a revolving or static pool of assets designed to generate the cash flows used to pay interest and principal on the securities. Transaction types vary widely and can be collateralized by financial, operating, or corporate assets. At MIM, our strategy is built across five broad sectors: Consumer, Commercial, Renewables, Alternatives Financing and Residential Mortgage Backed Securities. Behind each of these are a multitude of subsectors, including consumer loans, credit card receivables, Net Asset Value (NAV) loans, container leases, Commercial Property Assessed Clean Energy (C-PACE), and residential solar loans, to name but a few. Deals are typically negotiated between an issuer and investor(s) and are not widely syndicated.

The PSC market has grown in part due to the broad expansion of private capital lending following the Great Financial Crisis. As banks pulled back from certain types of lending due to regulatory and capital constraints, the PSC market developed to fill the gap. And this dynamic has only accelerated in recent years.

While unfortunately no reliable source currently compiles and publishes data on PSC transactions, MIM estimates that overall annual market volumes may reasonably stand in the $100 billion to $200 billion range.

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Distinguishing PSC from Public ABS

The PSC market is similar to Public ABS, but the private investor has more influence over the terms of each deal. This includes direct negotiation with issuers over what goes into the collateral pool, as well structural items such as covenants, trigger events, and make-whole provisions. This can result in enhanced protections to mitigate against downside risk compared to public markets. The PSC market can also offer higher spreads in return for the reduced liquidity compared to widely syndicated public offerings.

Why do issuers tap the PSC market?

Issuers can be categorized into several distinct groups and seek financing in the PSC market for a variety of reasons. First-time asset-backed issuers benefit from certainty of execution and reduced syndication complexity in the private market, while overcoming a lack of awareness from public market investors. Initial issuance in the PSC market allows new issuers to learn the process across collateral pool, legal documentation, reporting, rating agencies, and investor communication.

Esoteric issuers are able to market complex transactions to a small group of sophisticated investors on a bilateral or club basis which facilitates the comprehensive underwriting needed to participate in these deals. Other issuers prefer the PSC market for its confidentiality, limiting the dissemination of sensitive information to the public market.

In addition, the PSC market can accommodate a range of transaction sizes, from small issuances too modest for the public market up to very large multibillion dollar deals which the public market might struggle to digest. Moreover, the PSC market generally remains open during periods of market volatility; if public markets are closed, issuers may still be able to obtain financing through the private market.

Finally, some established 144A issuers appreciate the ability to diversify their sources of funding in the PSC market. These ABS issuers can obtain financing for collateral or deal structures that may differ from their existing public shelves. For instance, MIM can offer delayed draw facilities which are not feasible on the public side. These privately negotiated structures can result in pricing wider than public market spreads while often offering additional credit protections.

The Usefulness of Private Structured Credit in a Portfolio

PSC has found favor with many insurance companies who typically use a strategic asset allocation (Strategic Asset Allocation: Balancing Art and Science) model. PSC can carry a particular appeal for insurance companies because deals are generally rated investment-grade by rating agencies, providing attractive spread per unit of Risk-Based Capital which makes it an efficient asset class to help optimize insurance portfolios. The higher yields and capital-efficient deals can help support various business line liabilities within an insurance company, such as annuities and pension risk transfers. As an example, since inception in 2019, MIM's PSC strategy has achieved historic spreads of 250-270bp for mostly NAIC-1 assets.

In the context of modern asset management strategies, which increasingly strive for diversification and risk mitigation, another key benefit is the exposure to deals not commonly found in public markets, and thus opportunities for diversification that can help manage total risk across a portfolio.

In terms of maturity, PSC can be a good fit for shorter portfolios as well as a useful component to barbell with longer dated credit. MIM originates opportunities with a weighted average life ranging from 2 years to 12 years, offering assets across the curve depending on specific portfolio needs. The asset class also includes both amortizing and bullet structures which can further help to achieve ALM objectives.

Risks to Be Mindful of in the PSC Market

Credit risk is the primary factor requiring the attention of investors in the PSC market. Given the various sectors available, ranging from consumer credit to commercial and other esoteric asset classes, each requires its own unique underwriting approach. Across all of these sectors there are common due diligence areas focused on sponsor, collateral and structure related issues. Careful underwriting and analysis are critical to identify credit risks and determine the best methods to mitigate risk and strengthen investor protections.

A lack of liquidity is another consideration when investing in PSC transactions. Most PSC deals are highly bespoke in nature and do not have an active secondary trading market. Thus, it is important that investors address liquidity needs from other asset classes in their portfolio and that the benefits of enhanced structural features and pricing from PSC accrue in their illiquid asset bucket.

Another aspect to consider in the PSC market is operational risk. Many transactions are executed on a physical-settlement basis which requires coordinated efforts across Investment, Legal and Operations teams to close and fund a deal. Certain PSC transactions may feature delayed draw funding structures which require a higher degree of operational support to manage draw requests and process wires.

Manager selection is also an important factor to carefully evaluate in the PSC market. New manager entrants may not possess the full skill set and experience required to negotiate and underwrite PSC transactions. It is critical to select a manager that not only has the capabilities to structure a proper set of investor protections but also can manage ongoing transaction responsibilities such as deal surveillance and amendment requests.

MIM's Approach to PSC

At MIM, our PSC strategy has always been rooted in a balanced and measured approach. We emphasize disciplined underwriting and avoidance of aggressive deal structures and the more competitive sectors in the market. The majority of our portfolio is in a senior position which sits atop the priority of payments and protects against underperformance in collateral and general macroeconomic stress. MIM's focus on negotiating favorable terms which offer credit protections to our investors has been a hallmark of our strategy. We believe it is important to be willing to walk away from a deal if unable to negotiate appropriate structural protections.

The MIM platform maintains a deep bench of credit analysts with coverage across numerous sectors and industries, hence achieving a high level of expertise and knowledge that allows us to underwrite complex transactions across many different parts of the economy. We search for bonds backed by less commonly-funded assets, which may have some complexity to them and can potentially lead to better relative value. We have interest in transactions where other investors may lack expertise, and believe finding deals without natural homes is a better path to yield enhancement than moving down the capital structure in more publicly-traded alternatives.

In addition, deep relationships play a key role in sourcing opportunities for a PSC portfolio. Major players are often searching for partners with deep pockets who can deliver all the unique financing needs of the transaction while understanding sophisticated structures. We believe our ability to leverage our size to offer bilateral financing solutions to issuers provides a key advantage. MIM is capable of writing tickets in the $100-300 million range.

Our approach contrasts with some market participants who opt for a high percentage (70%+) of mezzanine tranche financing strategies. This strategy might offer higher spreads for a given rating compared to senior tranches, but the mezzanine tranche is subordinated, thinner, and thus more susceptible to higher losses in the event of underperformance.

Moreover, smaller firms with restricted team sizes and moderate capital allocations face considerable limitations in their ability to originate bilateral and small club transactions, which are a cornerstone of the market. These firms often participate in agented PSC deals but may struggle to originate direct transactions. The MIM PSC team has developed and cultivated strong relationships across the structured products community, including with issuers, bankers, rating agencies, and other investors. Ongoing meetings, calls, conferences and other touchpoints serve to stay in front of sourcing new transaction opportunities.

From a credit rating standpoint, MIM works with deal sponsors to obtain explicit NRSRO[1] ratings on all of our deals. The ratings on our transactions are assigned based on published methodologies from the rating agencies and include a new issue rating rationale as well as ongoing annual rating confirmations. Depending on the specific sector, the deals in our portfolio carry ratings from one of five rating agencies: Moody's, S&P, Fitch, KBRA and DBRS/Morningstar. The ratings assigned to private structured credit deals are typically private and not published on the company website; rating letters and reports are made available directly to the investor group.

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Conclusion: Navigating the PSC Landscape with MIM

In conclusion, the volatile and rapidly evolving financial market landscape underscores the need for investment strategies that balance risk and return effectively. For insurance companies, this balance is particularly crucial, given the specific regulatory and market challenges they face. MIM's conservative approach to PSC, backed by a deep bench of credit analysts and an emphasis on strong transaction structures, can provide a roadmap for insurance companies considering investment in PSC.

We believe with its attractive yields, capital efficiency, structural protections and sector diversification, PSC is an appealing investment option that can be an important contributor to the performance of insurance portfolios. We recommend insurance companies explore PSC as a strategic component of their portfolio, leveraging MIM's expertise for effective navigation of the PSC landscape.

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Endnotes

[1] Nationally recognized statistical rating organization

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