APOLLO

Flexibility Is Key: Why Invest Opportunistically in Private Credit

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One of the hallmarks of the post-Global Financial Crisis (GFC) world is the increased occurrence of periods with higher volatility in capital markets. While this new volatility regime might have negative impact on investments if not properly managed, it can also create opportunities for those investors willing to embrace this new normal and who are open to adding flexibility to portfolios. While this is true in a general sense, we believe that a flexible approach is beneficial in private credit portfolios.

That's because a flexible mandate can enable investors to allocate dynamically across the credit spectrum, capitalizing on opportunities that arise during different market regimes. In our view, the ability to seek and exploit opportunities on a relative-value basis can lead to more diversified portfolios and, ultimately, potential higher risk-adjusted returns.

As shown in **Exhibit 1**, opportunities can change based on where we are in the credit cycle. In periods of lower volatility, for example, high-yield bonds, leveraged loans, and direct origination tend to be favored as investor optimism drives risk appetite. In periods of higher volatility and dislocated markets, on the other hand, distressed and secondary credits often emerge as potentially lucrative targets as market volatility creates dislocated valuations.

KEY TAKEAWAYS

- Capital markets have, in our view, entered a new regime of higher volatility that, when properly managed, can create attractive opportunities for investors who are open to adding flexibility to private credit portfolios.
- A flexible, relative-value based mandate can allow investors to allocate dynamically across the credit spectrum, capitalizing on opportunities that arise during different market regimes, especially periods of dislocation.
- An opportunistic approach can lead to more diversified portfolios and, ultimately, potential higher risk-adjusted returns. In today's environment, we see attractive opportunities to allocate among private corporate credit, asset-backed finance (ABF), and dislocated credit.
- We see investors deploying flexible strategies alongside private credit, as a multi-asset class strategy, or as an "opportunistic" sleeve of credit portfolios.

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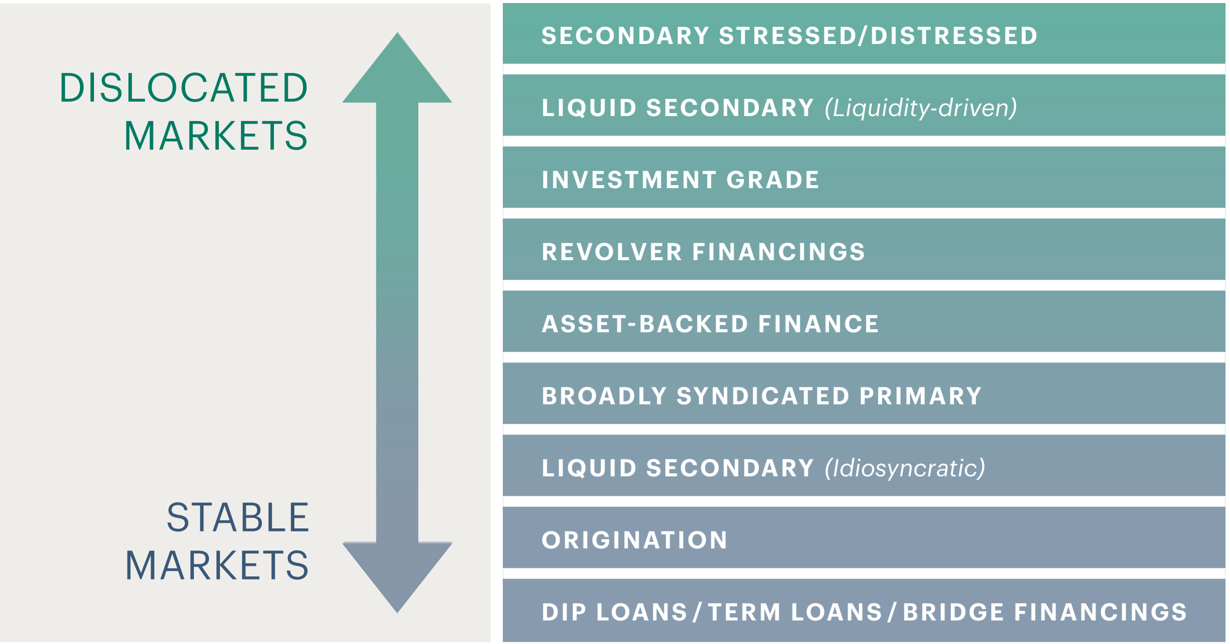
Exhibit 1: Flexibility can allow investors to seek opportunities across the credit spectrum during both stable and dislocated markets



For illustrative purposes only.
Source: Apollo analysts

The key question then is, what are the key variables to monitor when considering shifting allocations across the credit spectrum? While there is no one-size-fits-all answer to that question, we believe that the below set of specific developments should be considered:

- **Macro Environment:** A full understanding of expectations for aggregate economic growth, inflation, interest rates, consumer spending, lending, among others, is a paramount element determining allocations over time.
- **Sector/Asset Specific Trends & Relative Value:** Dislocations and valuation imbalances can occur at any time, and they can happen quickly across sectors, industries, and asset classes. Monitoring those trends with a keen eye on relative value is an important component of a flexible strategy.
- **Historical & Current Valuations:** Full historical knowledge can help contextualize today's prices and is a key input in assessing current valuations.
- **Technical Supply & Demand:** Supply and demand balances can change over time for many different reasons, ranging from shifts in macroeconomic policy to technical reasons, such as higher demand for capital in a particular active sector (e.g., clean transition, artificial intelligence) or other technicalities (i.e., an unusually high maturity wall).
- **Potential Near-Term Catalysts:** Constantly seeking to identify what can become potential triggers of change to an existing regime could mean trying to anticipate the next move in interest rates to exploring technical behavior of a particular asset or asset class.
- **Risks & Liquidity:** A wide-ranging view of potential risks is a key component of a successful opportunistic strategy, in our view. As is a full analysis of the liquidity environment. In other words, an opportunity must be attractive and actionable at the same time.

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Flexibility can also allow for efficient scaling of deployment in times of market stress, especially when the manager has a keen eye on high-quality assets. **Exhibit 2** outlines how capital can be deployed under periods of stable and volatile markets.

For example: In times when credit spreads are stable, keeping some dry powder in the eventuality of dislocations can be a sound strategy. Conversely, deploying incrementally into dislocation as spreads widen can be advantageous.

Exhibit 2: Flexibility can allow for efficient scaling of capital deployment

	Idiosyncratic Opportunities	Liquidity-Driven Opportunities
BACKDROP AND DEPLOYMENT	• High yield spreads **STABLE** • A fraction deployed when volatility remains muted and majority deployed **in event of dislocation**	• High yield spreads **VOLATILE** • Deployed **incrementally into dislocation as spreads widen**
INVESTMENT CHARACTERISTICS	• Derived from **issuer-specific circumstances** • **Short-term catalysts and instances to drive structure/terms** (e.g., Debtor-in-Possession (DIP) loans, direct originations, bridge financings, struggling syndications)	• Driven by **forced selling by liquidity-constrained, passive investors** seeking to offload risk quickly • Seeking fundamentally strong, performing assets that trade down due to **non-economic reasons**
DOWNSIDE PROTECTION	**High-conviction, top of the capital structure investments with strong cash flows and significant asset coverage**	

Source: Apollo analysts

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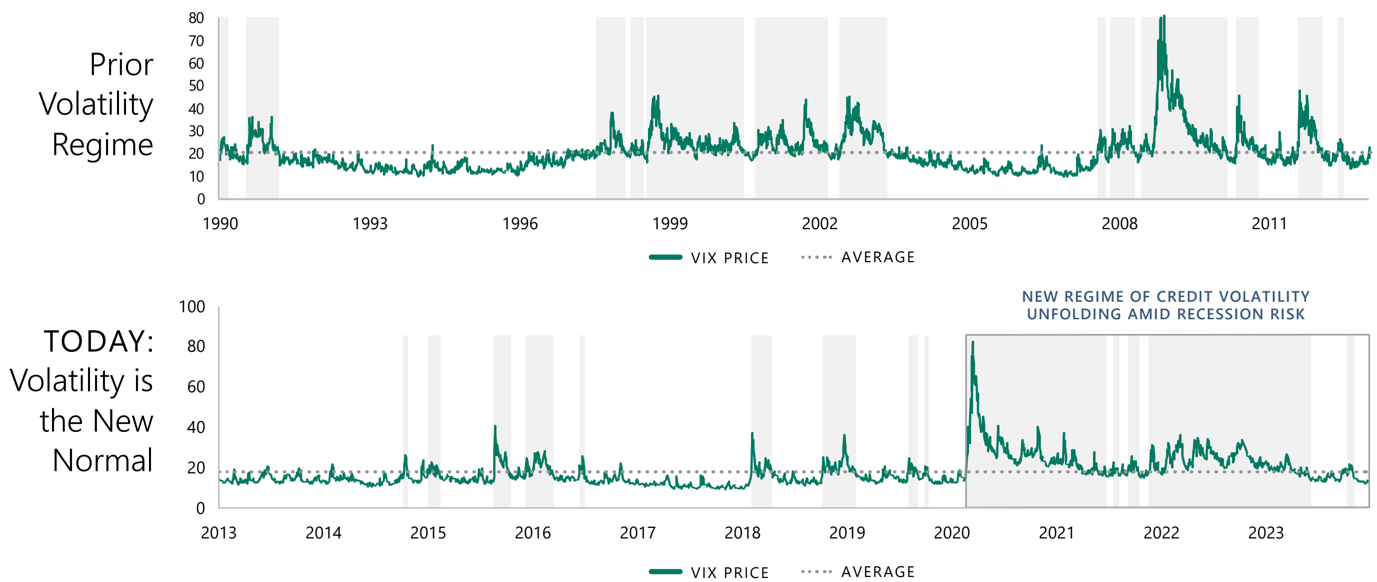
Additionally, as previously discussed, more frequent periods of dislocation can create more opportunities for flexible investors.

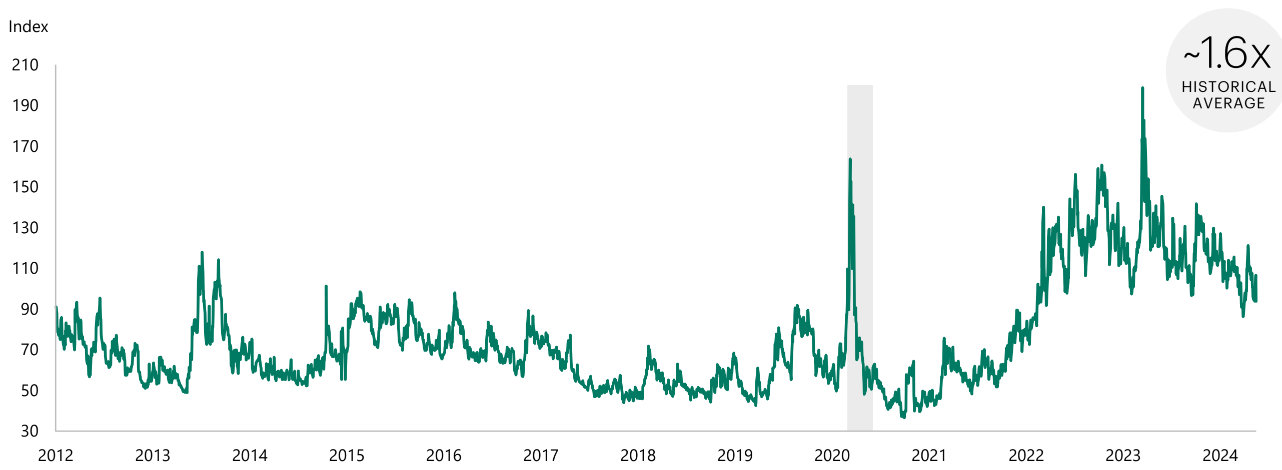
As shown in **Exhibit 3**, equity market volatility—measured here by the Chicago Board Options Exchange's CBOE Volatility Index (VIX)—was largely benign in the period from 1990 to the culmination of the GFC in 2008, despite several economic recessions experienced during that time. Volatility stabilized somewhat in the early 2010s, but it has been relatively high since the onset of the Covid pandemic in 2020. Similarly, interest rate volatility—as gauged by the Merrill Lynch Option Volatility Estimate (MOVE)—has also been above historical levels (**Exhibit 4**).

Exhibit 3: A higher volatility regime appears to be the new normal in equities...



Data as of December 31, 2023.
Daily VIX price data from January 1990 through December 31, 2023.
Source: Bloomberg

Exhibit 4: : ...and fixed income



Data as of March 27, 2024.
The Merrill Lynch Option Volatility Estimate (MOVE) Index is an interest-rate volatility barometer.
Sources: Bloomberg, Apollo analysts

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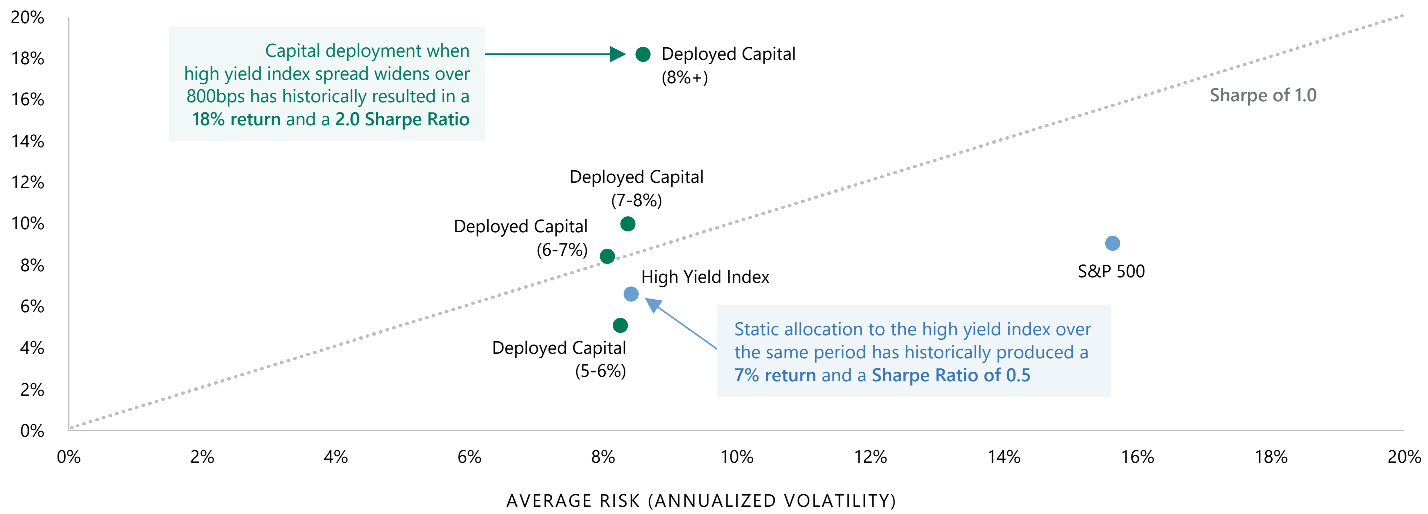
Higher volatility can lead to more frequent periods of dislocation, and we believe that those investors with the flexibility to deploy capital in times of dislocation can reap benefits over time. In fact, as shown in **Exhibit 5,** capital deployed during times of dislocation has yielded higher returns historically. For example, capital deployed when high-yield spreads widen over 800 basis points has historically resulted in a 18% return for investors (translating into a 2.0 Sharpe ratio) versus an annual 7% return when capital was deployed statically to the asset class.

Exhibit 5: Capital deployed during periods of dislocations has historically produced strong returns



Data from December 31, 1996 to December 31, 2023.

Sources: Chart above represents the hypothetical average risk/return of an investment in the JP Morgan High Yield Index, assuming a two-year holding period. The green dots represent the hypothetical average risk/return based on different initial investment dates when the option-adjusted spread (OAS) of the JP Morgan High Yield Index is between the values noted in parentheses. The blue dots represent the hypothetical risk/return based on a static allocation to the JP Morgan High Yield Index and S&P 500 Index over the full time period.

Where are opportunities today?

With all that in mind, where do we see opportunities across the credit spectrum today? In the remainder of this paper, we will focus on three specific segments of the market: private corporate credit, asset-backed finance (ABF), and dislocated credit.

Private Corporate Credit

The current slowdown in bank lending has created significant opportunities in private corporate credit (**Exhibit 6**). Traditional lenders are increasingly constrained by regulatory burdens, leaving a gap for alternative lenders. As banks pull back due to heightened capital requirements, private lenders can step in to fill the void and provide much-needed financing. This scarcity of financing, combined with strong demand for credit, presents an opportunity for private corporate credit investors, in our view.

Additionally, a lackluster exit environment has driven private equity sponsors to seek non-bank financing solutions due to uncertain public markets. With narrow initial public offering (IPO) windows and still historically slow M&A activity (although activity picked up somewhat after the Fed pivot in December), private credit has emerged as a crucial funding source, which can offer sponsors the flexibility and capital required in today's challenging market conditions.

Despite tighter spreads, we believe private corporate credit can still offer healthy yields and lower average leverage compared to public markets. Attractive entry points await disciplined investors, as tightened spreads and appealing valuations can offer well-structured deals with strong downside protection.

In our view, large-cap originations can offer attractive opportunities, especially for lenders who can execute efficiently (**Exhibit 7**). The ability to provide swift, bespoke solutions can give private lenders an edge over traditional financial institutions, allowing them to address the financing needs of large corporate borrowers. This agility can position private credit investors to capture significant value in the current landscape, especially as structural shifts from banks to alternative lenders continue to gain momentum.

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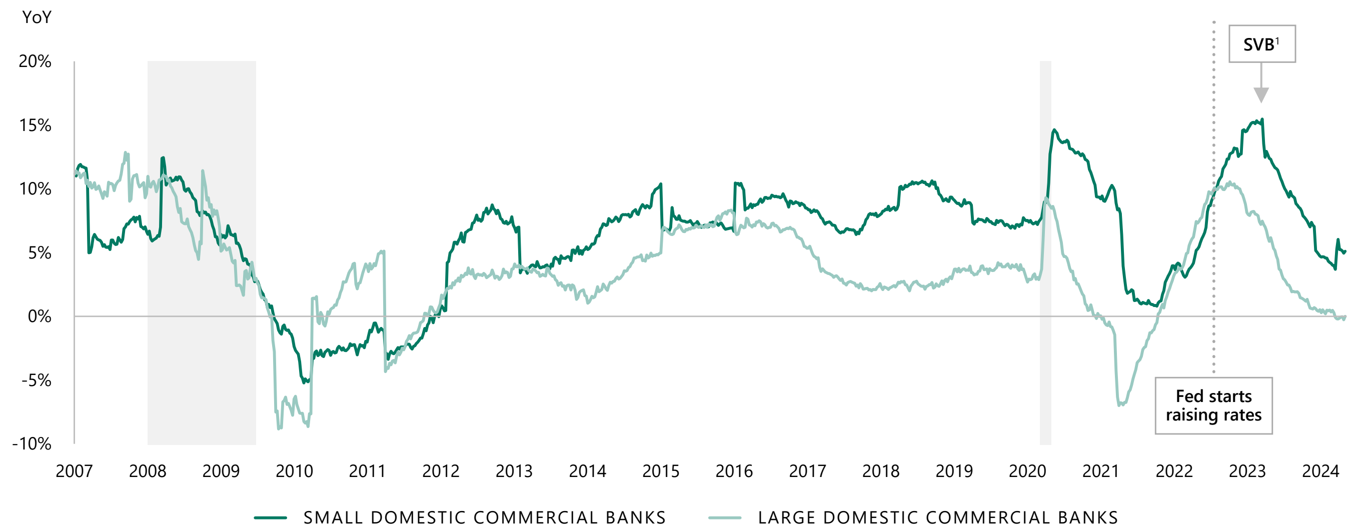
Exhibit 6: Bank lending growth is slowing rapidly, creating opportunities for private credit investors to fill the need for financing

Lending has faced headwinds following Fed rate hikes and regional bank challenges



Data as of January 31, 2024.

1. Silicon Valley Bank (SVB) failed on March 10, 2023.

Sources: Federal Reserve Board, Haver Analytics, Apollo Chief Economist

Exhibit 7: Large corporate origination can be attractive for lenders with scale, where market dynamics allow them to be price makers

The White Space: The Large Corporate Origination

All-weather, scaled private lending solution that can be accessible to experienced, well-capitalized managers

Target Company EBITDA	Coupon
$100mm+ ✓	SOFR[1] + 500-575 bps ✓
Original Issue Discount	**Average LTV**
1-2 points ✓	30-40% ✓

Broadly Syndicated Loan Market

Concentrated buyer base of public loans accentuates volatility and uncertainty

Target Company EBITDA	$100 mm +
Coupon	SOFR[1] + 300–350 bps
Original Issue Discount[2]	0–1 points
Average Total Leverage	5.0x

Middle Market Lending

Mature landscape with conventional lending characteristics

Target Company EBITDA	$30–75 mm
Coupon	SOFR[1] + 500–550 bps
Original Issue Discount[2]	1–2 points
Average Total Leverage	~45–50%[3]

Data as of June 2024.

1. SOFR is a broad measure of the interest rates banks pay each other for short-term loans collateralized by United States Treasury securities.
2. The original issue discount (OID) is the difference between the original face value amount and the discounted price paid for a bond. OID bonds have the potential for gains since investors can buy the bonds for a lower price than their face value.
3. As of June 2023.

Source: PitchBook LCD

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Asset-Backed Finance

Over the past decade, private credit lending has predominantly focused on corporate borrowers, leaving a substantial opportunity for investors in asset-backed finance. While the corporate direct lending market has attracted significant attention and capital, the asset-backed finance market remains relatively underserved and less competitive, in our view.

Asset-backed finance is characterized by providing exposure to diversified collateral pools across various idiosyncratic asset classes. The ability to invest in assets like consumer loans, auto loans, and real estate-backed securities can provide diversification benefits that can stabilize portfolios during periods of market stress. Additionally, ABF has demonstrated resilience in periods of economic downturns—as investment-grade default rates remain exceptionally low compared to other asset classes (**Exhibit 8**).

Exhibit 8: ABF has demonstrated resilience across periods of market stress

Investment grade default rates by asset class (annualized)

Data as of 1Q 2023.

Note: Investment grade ABS defaults are based on US ABS as defined by Moody's. Investment grade CLOs represent US CLOs as defined by Moody's, except 1Q23 where global CLO defaults from Moody's are used due to lack of available data on US-only CLOs. CLO & ABS default data are not available in "savings & loan crisis" and "S&L recession / gulf war" periods due to limited ABS/CLO market at the time.

Source: Moody's

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Additionally, we believe asset-backed finance can present an attractive risk-return profile for investors seeking diversification and downside protection. With robust lender protections and attractive yields, the market can provide exposure to less correlated and resilient collateral pools (**Exhibit 9**). This diversification can be valuable in the current environment, where volatile corporate credit markets heighten the need for stability.

The less competitive nature of ABF can allow well-positioned investors to identify and capitalize on compelling opportunities. As shown in **Exhibit 10**, most of the growth in private credit lending focused on corporates over the last decade, which, in our view, creates a strong potential sourcing opportunity in the ABF space, which remains a highly unpenetrated market when compared to corporates.

Exhibit 9: ABF can provide diversification and lower correlations to corporates

Asset-backed spreads trailing 12-month correlation to US Corporates

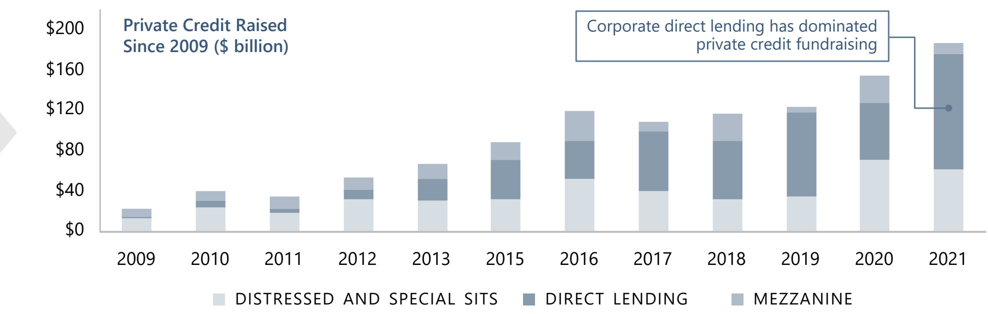
Rating	US BSL CLO	US Conduit CMBS	US Private Student Loan ABS	US Prime Auto ABS
AAA	0.51	0.69	0.63	0.40
AA	0.59	0.65	0.70	0.56
A	0.69	0.70	0.72	0.67
BBB	0.74	0.73	0.70	0.65
BB	0.66	NA	NA	NA
Average	**0.64**	**0.69**	**0.69**	**0.57**

Data as of May 2023.

Sources: Historical spread data sourced from JP Morgan and Bank of America from January 1, 2012 through May 5, 2023. There can be no assurance that historical trends will continue or will not reverse.

Exhibit 10: ABF can offer strong sourcing opportunity in a less competitive space

Over the last decade, the growth in private credit lending has focused mostly on corporates…



…creating a potential sourcing opportunity in asset-backed finance

Corporate Direct Lending

Asset-Backed Finance

1. Reflects all unsecured corporate across broadly syndicated loans, direct corporate and high yield made by commercial banks and nonbanks per Federal Reserve. 2. Source: 2022 Preqin Global Private Debt Report, October 2021. 3. Sources: SIFMA, JP Morgan, Apollo Analysts, Financial Stability Board report on total private financial assets originated and held by non-banks, as of Q2 2022. 4. Source: Preqin, as of January 15, 2023. Includes all active funds that primarily or solely invest in asset-backed products.

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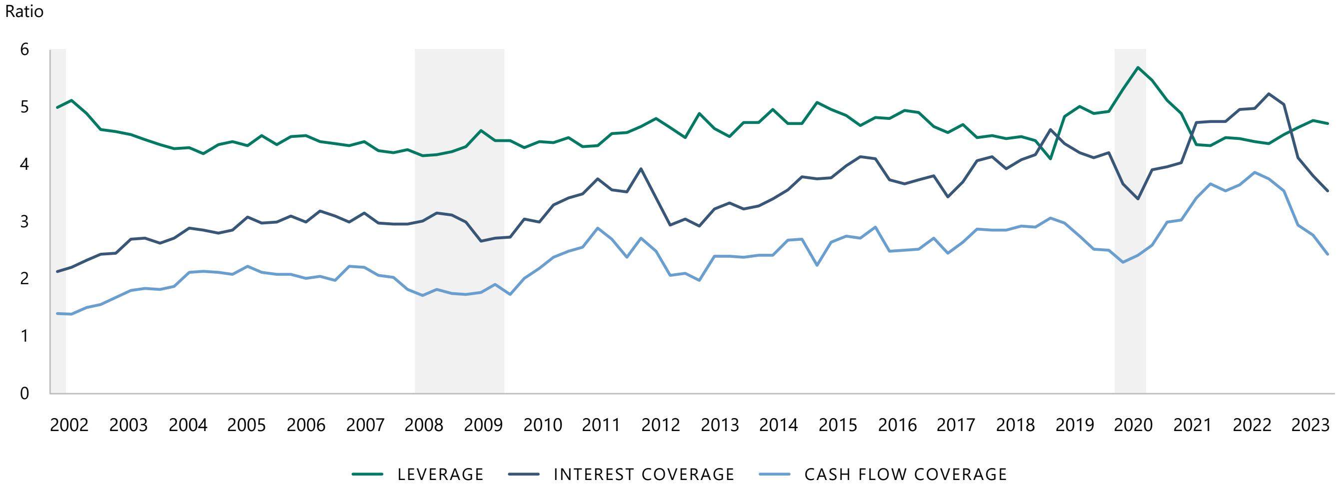
Dislocated Credit

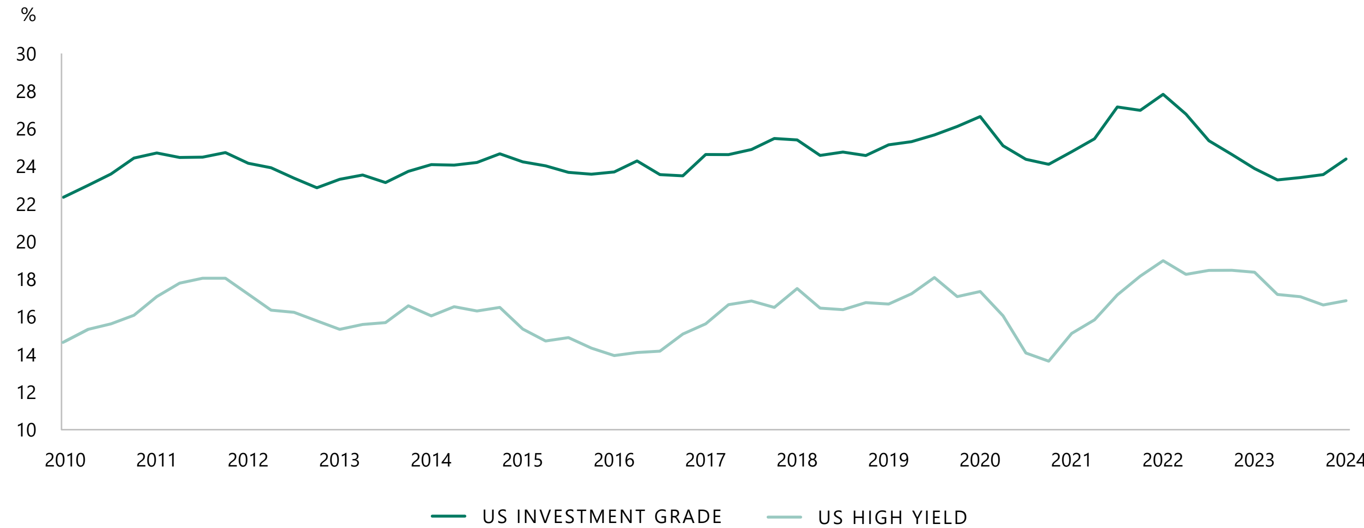
We believe that the dislocated credit market can offer significant opportunities for flexible investors amid deteriorating fundamentals in high-yield and leveraged loans (**Exhibit 11**). Rising default rates and weakening credit metrics can signal growing stress in these markets. In leveraged loans, median credit metrics have shown deterioration, while high-yield segments face declining EBITDA margins.

Exhibit 11: While spreads are tight, higher yielding segments show some deteriorating fundamentals, including leveraged loans and high yield

Median credit metrics for US leveraged loans universe



Median EBITDA margin



Data as of March 2024.

Sources: Pitchbook LCD, Apollo Chief Economist

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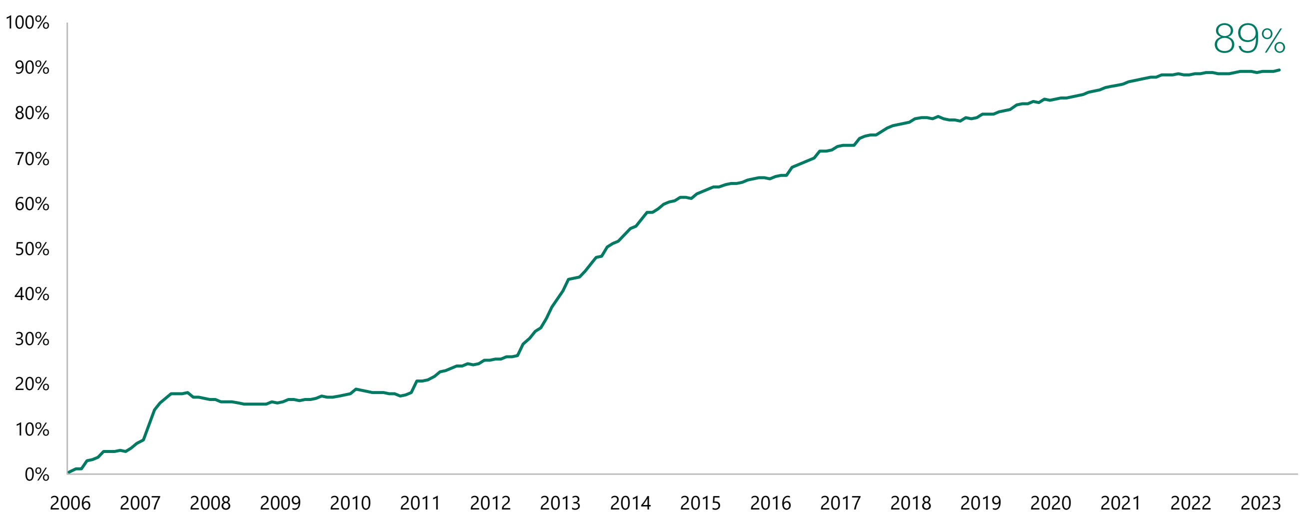
What's more, as the macroeconomic backdrop becomes more challenging, underwriting standards have significantly deteriorated in recent years with loans increasingly lacking robust credit documentation. As show in **Exhibit 12**, over 89% of leveraged loans now feature weak covenants or are "covenant lite." This trend is important because, in periods of market stress and heightened default rates, the absence of strong covenants can lead to lower recovery rates and inadequate investor protection.

Exhibit 12: Underwriting standards have grown lax

Loans with low credit documentation have been on the rise



Data as of 2023.
Sources: Pitchbook LCD, Barclays Research

Deploying flexibility in portfolios

Opportunistic strategies may be deployed in fixed income portfolios in the following ways:

1. Alongside private credit sleeve as a potentially yield enhancing strategy.
2. As a multi-asset class strategy, capitalizing on opportunities across public/private and corporate credit/asset-backed finance on a relative-value basis.
3. Part of an "opportunistic bucket" to allow for quick access to new opportunities.

Conclusion

We believe that capital markets have entered a new regime of higher volatility that can create attractive opportunities for investors who are open to adding flexibility to portfolios. While this is true in a general sense, we believe that a flexible approach can be beneficial in private credit portfolios.

A flexible mandate can allow investors to allocate dynamically across the credit spectrum, capitalizing on opportunities that arise during different market regimes. When exploited on a relative-value basis, we believe that an opportunistic approach can lead to more diversified portfolios and, ultimately, potentially higher risk-adjusted returns. In the current environment, we potentially see attractive opportunities in private corporate credit, asset-backed finance (ABF), and dislocated credit, with investors deploying flexible strategies alongside private credit, as a multi-asset class strategy, or as an "opportunistic" sleeve of portfolios.

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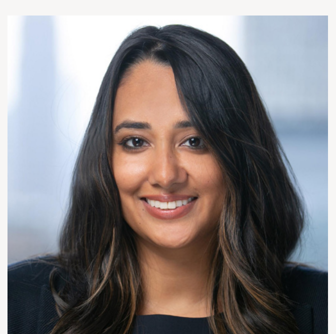

Akila Grewal

Partner, Global Head
of Credit Product

Akila Grewal is a Partner in Client and Product Solutions, where she serves as the Lead of the Institutional Product Specialist team and Co-Lead of Product Management focused on strategies in Credit across Apollo's platform. Akila sits on several committees, including the Firm's Credit Management Team, Credit Allocations Sub-Committee, and the Apollo Opportunity Foundation's Council. Akila also serves on the not-for-profit Braven's NYC Board as well as the PK AirFinance Board.

Prior to joining in 2016, Akila was on the Proprietary Trading and Risk Management team at Mariner Investment Group. Previously, she was in the Business Development group at MKP Capital and she started her career at Credit Suisse on the Hedge Fund of Fund's Portfolio Management team. Akila graduated from New York University's Stern School of Business with a BS in Finance and is a CFA charterholder.

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