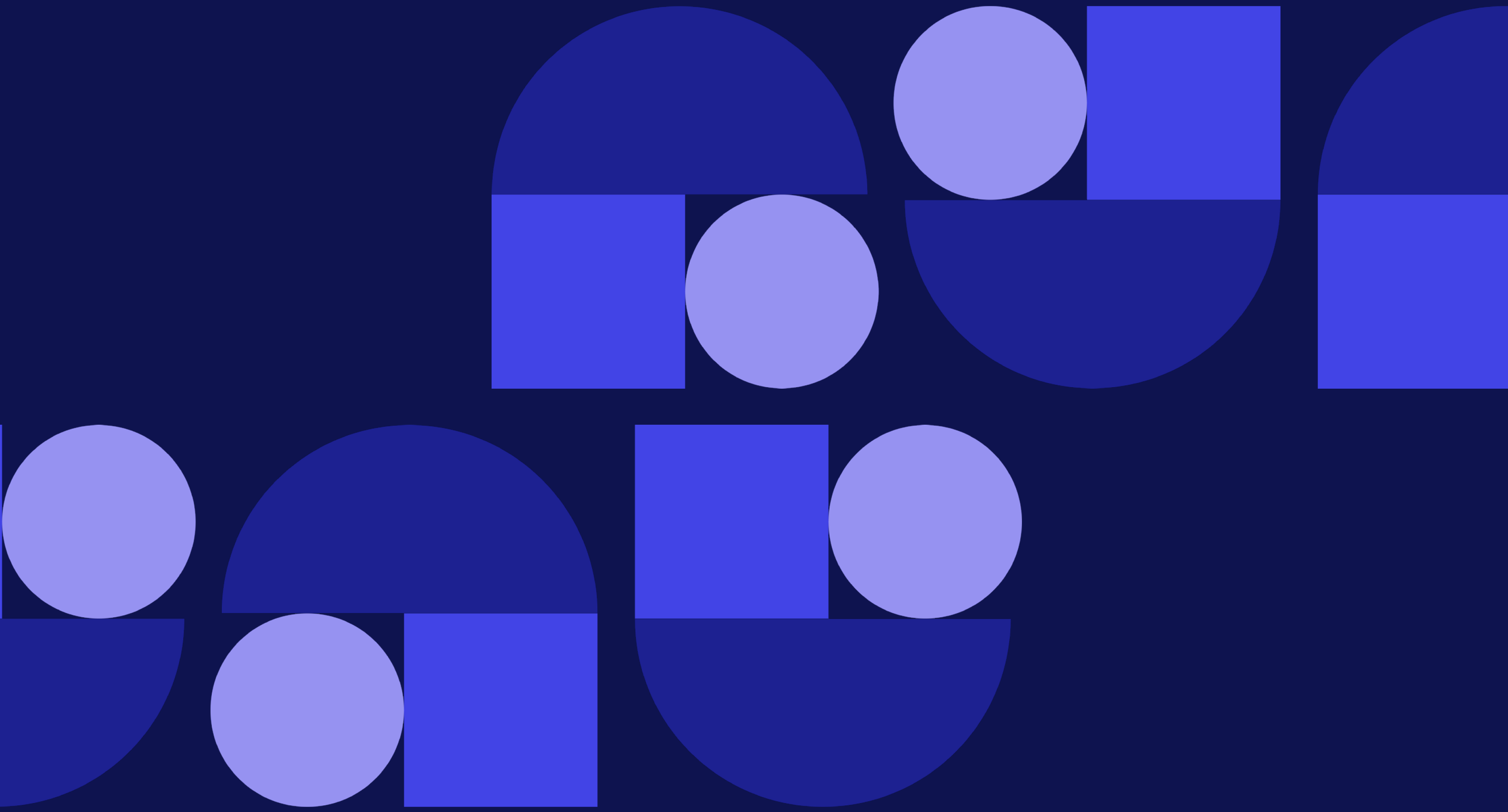
CAIS IQ

Private Credit

Foundations of Alternative Investments



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Private Credit, an Introduction

Private credit, also known as private debt, generally refers to **loans that are privately negotiated between a lender and a borrower.** The asset class itself has grown substantially following the 2008 Global Financial Crisis as banks de-risked their balance sheets and tightened their lending standards.[1] The void left as a result was subsequently filled by non-bank (private) lenders.

These alternative lenders serve borrowers and help investors seeking yield in a low interest rate environment. **Private credit has the potential to provide higher yield opportunities than traditional fixed income investments, as it provides capital to borrowers at a premium due to the illiquid nature of private credit.**

What is Private Credit?

Private credit consists of a wide variety of strategies often considered comparable to non-investment grade syndicated leveraged loans and high-yield bond markets. While these comparable securities are rated by a ratings agency and are relatively more liquid, private loans can be priced to include an illiquidity premium, which varies over time (e.g. 100-500 basis points).[2] Additionally, given that borrowers seeking private financing have typically been unapproved, or are not able to access bank lending, the credit, while unrated, is typically below investment grade (e.g. B or BB equivalent).[3]

There are several reasons that borrowers may seek capital from non-bank lenders including:

- Flexible structures
- Confidentiality
- Speed and certainty
- Credit worthiness
- Value-add lenders

While being potentially exposed to greater credit risk, **private credit may exhibit lower volatility as loans are typically held by a single originator and a secondary market may not exist.** Furthermore, those that do trade, may not trade with enough frequency or depth. This may result in less valuation adjustments compared to more frequently traded securities that are regularly marked-to-market. Yet, certain areas of private credit, such as those that invest in the distressed debt of highly syndicated offerings or distressed sovereign issuances, may mark-to-market quite often and demonstrate high volatility.

For investors willing and able to tolerate illiquidity, **private credit can potentially provide attractive relative and absolute returns compared to other credit investments, while providing a diversification benefit to traditional allocations.**

[1] Mercer, Private Debt Asset Class Update, 2018.
[2] Ibid.
[3] Ibid.

Understanding the Different Private Credit Categories

Private credit covers a variety of different categories. Individual fund managers may focus on one or more of these and typically invest across industries or specialize within an industry. The most prevalent categories include:

- **Direct Lending:** This category generally includes private corporate loans that may be backed by the future cash flows or specific assets of the company. In terms of a real estate company, loans may be collateralized by the physical property. *Lending is typically in the form of senior, junior, or mezzanine debt.*

- **Distressed & Special Situations:** Lenders seek out companies that are undergoing financial difficulties or stresses, such as bankruptcy proceedings, with the intent of gaining control. By implementing an event-driven approach like this, lenders hope to benefit from a successful post-bankruptcy restructure/reorganization of the company, or from a loan-to-own strategy with the intent of becoming equity holders. Alternatively, they may follow a relative value approach whereby they look to capitalize on the belief that the publicly traded debt of a company is trading well below its par value and the manager's assessment of fair value. *Special situations can include debt investments across the capital structure, trading in the secondary market, direct origination, or distressed debt.*

- **Structured:** Structured debt is typically used by companies that have highly specialized and specific needs. Additionally, structured debt helps borrowers mitigate the risk of underlying assets through the process of securitization. *Collateralized loan obligations (CLO), asset-backed securities (ABS), and mortgage-backed securities (MBS) are all examples of structured debt.*

- **Specialty Finance:** This category of non-bank lending covers a diverse range of asset types that have differing correlations to broad economic conditions. *Debt within specialty finance typically gets classified by industry segment such as litigation finance, music/film royalties, structured settlements, and infrastructure finance, amongst many others.*

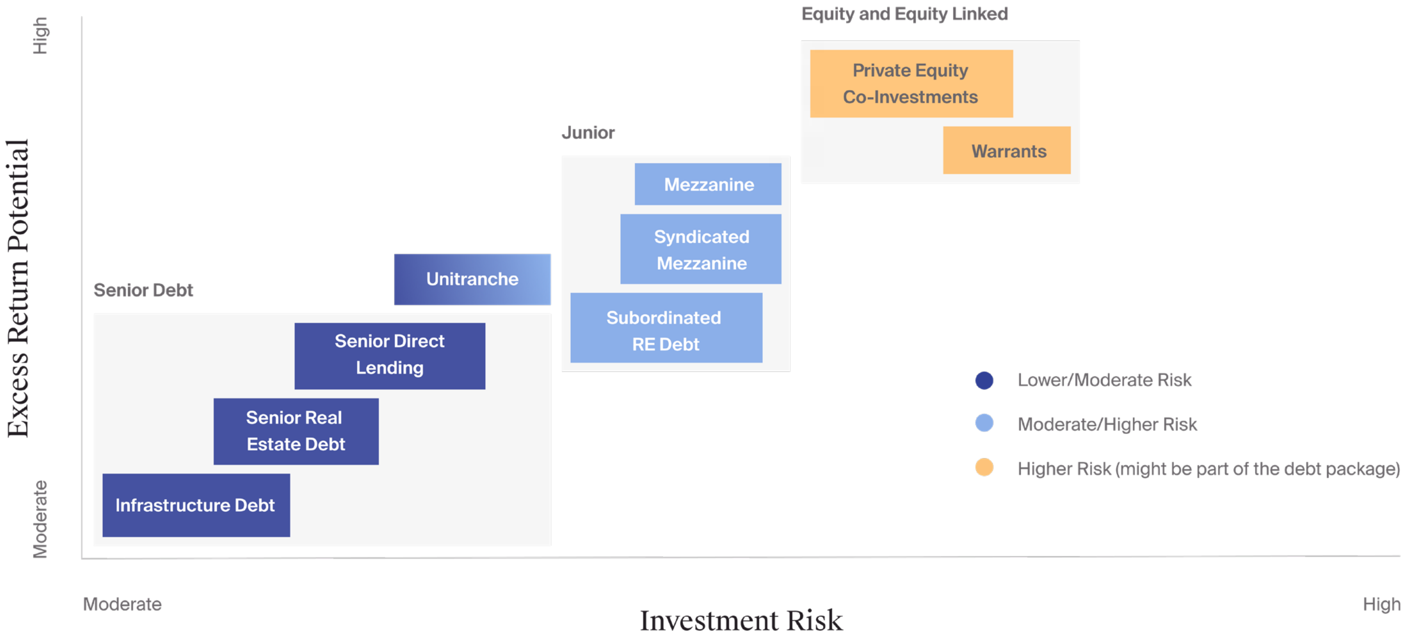
Core Foundations of Private Credit

Fixed income investments, like private credit, are typically considered to be less risky than equity investments. This is due to the senior claim on company assets if the firm defaults and/or bankruptcy occurs. The loans within a private credit investment can be apportioned to the different layers within the capital structure of a firm – see Figure 1 – from the more secure senior credit, to the hybrid senior/subordinated unitranche debt.

- **Senior debt** is typically the most senior position in the capital structure and is therefore considered the least risky position and generally secured by an asset or activity of the company. The relative protection afforded due to its seniority results in a lower total return profile with returns generally being driven by interest payments, as well as upfront origination fees and call protections.

FIGURE 1

Understanding Private Credit Risk and Return



Excess Return Potential
High
Moderate
Equity and Equity Linked
Private Equity Co-Investments
Warrants
Junior
Mezzanine
Syndicated Mezzanine
Subordinated RE Debt
Senior Debt
Unitranche
Senior Direct Lending
Senior Real Estate Debt
Infrastructure Debt
● Lower/Moderate Risk
● Moderate/Higher Risk
● Higher Risk (might be part of the debt package)
Moderate
Investment Risk
High

Source: Mercer. For illustrative and educational purposes only.

- **Junior debt** ranks below the senior debt and may include mezzanine debt and subordinated debt that can be secured or unsecured. It is subordinated to other types of credit but is senior to equity holders and, as such, is considered a hybrid between debt and equity. The increased risk of holding a lower claim to the asset of a company increases the return expectation of an investor. This added upside may come in the form of a higher coupon or interest rate, equity warrants or rights, or convertibility to common or preferred equity. These features provide the potential for further upside.

- **Unitranche** is a hybrid loan that combines both senior and subordinated debt into a single loan structure. Such an approach blends the interest rates of the two sources of debt and makes the structure into a more flexible offering for both borrowers and lenders.

Sponsored versus Non-Sponsored

Many private credit loans are issued to companies that have been acquired by a private equity (PE) firm via a leveraged buyout transaction. In such a transaction, the PE firm becomes a sponsor of the loan and the lender may negotiate terms with them, in addition to the company's management. **Sponsor-backed loans are considered to be less risky because the sponsor has a vested interest in the success of the company.** Private lenders often seek to build key relationships with top tier PE sponsors as this helps them to potentially receive deal flow. **Non-sponsor lending is typically sourced directly and may have the potential for higher contractual coupons or issuance fees due to the lack of a third-party sponsor.**

Potential Benefits of Private Credit

Private credit can provide access to borrowing for companies that otherwise would not be able to access the traditional syndicated bank loan market and therefore would have to seek higher cost financing from private lenders. Alternatively, these lenders can attract private companies that have access to the syndicated market but prefer the benefits of private credit including increased certainty of outcome, price and key terms, as well as the speed and confidential nature of private credit.

An additional potential benefit of private credit is that it generally does not experience the same J-Curve as other private market investments. **As a reminder, the J-Curve is a feature of the return profile for private market investments whereby early year returns are typically negative as management fees and other costs associated with ramping up a fund are incurred.** It may take several years for performance to turn positive as underlying investments are marked up to their current value, or gains realized, through exit transactions. **Due to the current income received from borrowers, early year returns are more likely to be positive resulting in a substantially different experience in private credit.**[4] This could be seen as a significant advantage over other private market investments.

Key potential benefits of private credit for investors include:

- **Return premium from illiquidity**
- **Persistent, large supply throughout cycles**
- **Lower volatility relative to publicly traded equity and credit**
- **Diversification benefits to traditional stocks and bonds**
- **Lower sensitivity to interest rates due to floating rate terms**
- **Softening of the J-Curve as the income component returns capital to investors earlier than other private market investments**

Potential Value Creation in Private Credit

There are several elements that can contribute to the return generated by private credit.

- **Floating Rate Coupons:** To partially compensate for the higher risk of default, private lenders issue credit at a spread above a certain benchmark – the U.S. Government 10-Year Bond or the London Interbank Offered Rate ("LIBOR"), for example. By doing so, the contractual coupon is likely to adjust over time as the benchmark rate adjusts. This leads such investments to have a lower duration, or interest rate risk, versus the traditional fixed income benchmark.

[4] Nesbitt, Stephen, Private Debt: Opportunities in Corporate Direct Lending, 2018.

- **Origination Fees:** This is a fee earned by the lender for underwriting and making a loan. Origination fees are considered as a part of the return stream from private credit. They are paid upfront and typically received prior to a loan making an interest payment.

- **Covenants:** Due to the highly negotiated nature of private credit loans, lenders may be able to negotiate stronger covenants and protections than in the syndicated bank loan market. Additionally, having greater access to the financial information of the borrowing company and through thorough due diligence, they can watch for early warning signs of financial stress and have clearer rights to take corrective action in the event of covenant breaches or defaults.

- **Non-Syndicated/Off-Market Deals:** Certain lenders may have a competitive advantage when it comes to sourcing attractive deals given their relationships with PE sponsors, repeat borrowers, or their reputation in the private credit market.

- **Paid In Kind ("PIK"):** Private lenders may issue credit at an assumed coupon rate, which in practice is not actually paid but rather "Paid In Kind." This means that the interest coupon, which would have been due, is actually added to the principal balance and due at maturity. Private lenders are able to offer this flexibility, typically at a premium cost of capital, to borrowers that otherwise do not have the current cash flow to service debt.

Noteworthy Risks of Private Credit

- **Illiquidity:** As loans are issued privately, an active secondary market for these loans may not exist. Additionally, the highly negotiated nature of private credit investments makes them less easily transferrable. Large banks may not hold any inventory of the loan at all and changes in their market value may not be reflected for some time.

- **Credit/Default Risk:** The historical default and recovery rates of private credit loans are difficult to estimate due to their private nature, creating greater uncertainty in the eventual performance of underlying loans relative to traditional fixed income securities, such as investment grade corporates and municipal bonds. Additionally, since in some instances the borrower may not have been credit-worthy enough to secure a loan from a bank, the risk profile of the underlying loan may be greater.

- **Lack of Control:** Investors will typically invest in a limited partnership and concede control of the investment making decisions to an investment advisor. They will rely on the investment advisor to navigate entry and exit from loans through the credit cycle.

- **Use of Leverage:** Some managers may seek to increase returns by applying leverage. While this can be quickly removed in times of stress, consideration needs to be given to the potential impact of applying leverage into a declining market and its impact on the overall fund's assets.

Accessing Private Credit

Funds are typically structured as **limited partnerships**, similar to those found in private equity investments. Unlike **private equity, however, private credit funds typically have a relatively short fund life.** This can be attributed to shorter maturity dates or prepayment prior to maturity. Additionally, some sponsors may structure funds in an **evergreen**, or **continuously offered private, closed-ended vehicle such as a Business Development Company ("BDC").**

Allocating to Private Credit

Diversification

- **Manager:** As with any asset class, investors should consider allocating to multiple managers given the active management of risk associated with private credit.

- **Strategy:** There are many different types of private credit strategies, each with differing risk and return profiles. Diversification of strategy can help ensure risk is not concentrated in one loan or credit type.

- **Vintage Year:** Investors should consider vintage year diversification, putting money to work over multiple vintages (i.e. do not put all private credit capital in one fund). Given the long-term nature of credit cycles, typically characterized by different stages that impact performance, allocating to private credit over multiple years (e.g. vintages across 5-10 years) helps to potentially mitigate risks due to market cycles and the timing of both entry and exit from private credit funds.

Manager Selection

Manager selection is a key component to risk mitigation in private credit and should cover several dimensions including strategy profile, investment team experience, sourcing capabilities, and credit expertise.

- **Strategy Profile:** In addition to assessing the ability of a manager to reach their stated return target, a strategy must be considered relative to its peers in the market. An assessment of a strategy's track record, along with qualitative and quantitative comparison, will aid this process. Consistency of implementation should be established, as well as whether a manager has moved out the risk spectrum and/or their core competency in search of return. An assessment of a manager's track record in times of stress should be considered to better understand their ability to manage a portfolio through market dislocations.

- **Investment Team Experience:** Since private credit is continually evolving it is prudent to carefully assess team experience. This should cover a review of their experience in private credit and direct lending, mezzanine investing and leveraged finance, and credit analysis.

- **Sourcing Capabilities:** As with other forms of private market investing, such as private equity, a successful private credit manager should have skill in deal sourcing. This generally requires not only resources and experience, but a vast network of contacts in local markets to ensure the most attractive deals make their way into a portfolio.

- **Credit Expertise:** Differences in loan type require unique skills to adequately assess the opportunity. For example, credit expertise is essential when conducting analysis on senior loans, whereas operational expertise is required for deals that may have a higher exposure to restructuring risk. Additionally, prior experience in underwriting, pay-off, recovery, and restructuring should be assessed.

Establishing an Allocation Strategy

Building a diversified private credit portfolio takes time and prudence. Several approaches to gain the desired exposure include:

- **Disciplined:** Create a capital deployment schedule that covers multiple years. Features such as loan types, covenants, and coupons may be different at different stages of the credit cycle. Therefore, building a position over time can access these underlying themes and help enhance return while diversifying risks.

- **Opportunistic:** The best managers are chosen independent of weightings to each category or loan type, and vintage diversification. The resulting private credit portfolio may produce a less than optimal allocation, or lack diversification by vintage years.

- **Hybrid:** Some investors may look to utilize a disciplined approach to build a core allocation to private credit, while at the same time, opportunistically commit to desired strategies as satellite exposures become available. ■

APPENDIX

Private Credit Terms

- **Business Development Company ("BDC"):** A BDC is a closed-ended investment company formed for the purpose of helping smaller companies who don't have access to traditional sources of borrowing. BDCs can be public or private and are usually structured as a regulated investment company (RIC) for tax purposes. This makes them popular with income orientated investors who typically receive high dividend yields due to the requirement of a RIC to distribute at least 90% of their taxable income to shareholders.

- **Direct Lending:** Senior loans made to mid-market companies without an intermediary. Direct loans may also include revolving credit lines, second lien loans, or unitranche facilities, the latter of which combines different debt instruments under a single umbrella.

- **Mezzanine Debt:** Subordinated debt, generally with features of preferred equity like warrants, increase the value of the debt. Mezzanine debt is often used in leveraged buyouts (LBOs).

- **Origination Fees:** A fee earned by the lender for underwriting and making a loan. Origination fees are considered as a part of the return stream from private credit.

- **Securitization:** The process whereby non-tradable assets, such as mortgages and receivables, are packaged together to create a new security. The goal of securitization is to create liquidity for illiquid assets.

- **Special Situations:** Debt investments made to companies that are typically experiencing some form of distress, or immediate catalyst, with the intent of gaining control. Special situations can include debt investments across the capital structure, trading in the secondary market, direct origination, or distressed debt.

- **Paid In Kind ("PIK"):** Private lenders may issue credit at an assumed coupon rate, which in practice is not actually paid but rather "Paid In Kind." This means that the interest coupon that would have been due is actually added to the principal balance and due at maturity. Private lenders are able to offer this flexibility, typically at a premium cost of capital, to borrowers that otherwise do not have the current cash flow to service debt.

- **Coupon:** The contractual periodic interest payment agreed to be paid by the borrower to the issuer.

- **London Interbank Offered Rate ("LIBOR"):** A market benchmark rate which reflects the rates at which banks will make short term loans to another high credit quality bank. Many interest payments are pegged to LIBOR as a reference rate.

- **Yield Curve:** A chart demonstrating the benchmark rate, such as U.S. Treasury rates, over multiple maturity dates.

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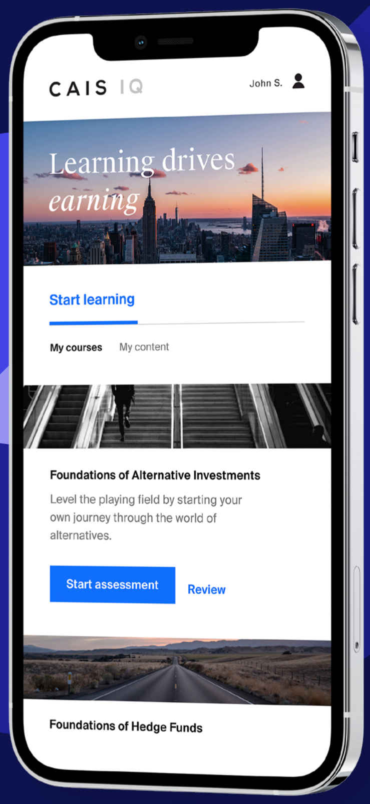

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