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What is Private Credit?

Note: “Private credit” is often used synonymously with direct lending, which this guide will focus on. However, it is also important to note other investment strategies that fall under the umbrella term “private credit”, such as alternative credit.

Companies are financed through either debt or equity. Most people are familiar with equity financing, which can be accessed either through the public markets (through IPOs and follow-on offerings) or through the private markets (private equity). Debt can be similarly divided into public and private markets. On the public side, companies can go to investment banks to issue corporate bonds that are publicly traded by institutional and retail investors. Increasingly, companies also seek to access private debt. Unlike public bonds or syndicated loans, these debt instruments are privately structured and held by one or a few lenders. The debt is not publicly traded and is typically held to maturity by the lender.

Over the past two decades, private credit (specifically, direct lending) has become one of the fastest growing asset classes with one of the highest average risk-adjusted return profiles. This growth and success can be attributed to the several factors, which can be divided amongst inherent characteristics of private debt investing and specific historical developments:

Historical developments:

1. Following the Great Financial Crisis, banks faced much stricter regulation that heavily limited lending capacity, especially for middle-market corporate borrowers. As a result, more of these companies became unable to find debt financing and turned to private credit.

2. The growth of private equity leveraged buyout activity over the past two decades due to the near-zero interest rate environment created a massive demand for debt financing (the “leveraged” in LBO). This massively expanded the reliance upon private debt markets.
3. As we exited the post-GFC zero-rate environment after the COVID inflation shock, private credit yields skyrocketed. Private debt instruments are typically floating rate, composed of a base rate and a spread component (SOFR +550 refers to a total interest rate of 5.5% above SOFR at any given moment). As the base rate rose from near zero to near 5%, private credit instruments returned total yields in excess of 10% – near or above the historical expected return of the S&P 500. This was an abnormally high return, considering that credit investments are always senior to equity investments (lower risk), and therefore should theoretically always offer a lower return. Because of this, the ability of certain private debt investments to offer a superior return at a structurally lower level of risk to either public or private equity investments contributed greatly to the explosion in popularity of the asset class.

Inherent characteristics:

1. Private credit funds can lend to businesses that cannot access public equity/debt markets because of their size, which results in greater yields.
2. Private lenders can provide financing solutions that are far more specialized to borrowers over a much shorter time horizon. Because of this, borrowers will be willing to pay a higher total yield to private debt investors.
3. Unlike public credit, private lenders can work with the companies they lend to. When a corporation is unable to pay the interest payments on bonds they’ve issued, they face a technical default and become distressed. However, if a business is facing temporary difficulties (economic slowdown, temporary lag in a certain sector, temporary spike in supplier prices, etc.), a private lender can restructure their debt instrument such that the borrower does not enter a default. For example, the lender could amend the loan such that the borrower may access payment-in-kind interest (PIK) rather than cash interest. Alternatively, the lender could grant a temporary waiver for interest payments in return for higher interest payments in the future. In both cases, the total return to the lender will be higher compared to suffering a borrower default (as with public credit).

What Firms Should I Apply To?

In general, buy-side (investing) roles directly out of undergrad are fewer compared to sell-side (investment banking) roles. As a subset of all buy-side roles, private credit roles can be even rarer to find. The two largest critiques of a buy-side or private credit role directly out of undergrad, rather than first spending two years at the analyst program of an investment bank before moving to buy-side, is that 1. There may not be as much of a structured training program and 2. Your skillset and brand reputation will be more pigeon-holed.

To mitigate both of these downsides, it is preferable to pursue a private credit analyst role at an established fund with an established analyst program (Blackstone, Apollo, KKR, Ares, Bain Capital, Antares, HPS). In terms of timelines, most private credit recruiting will run parallel to the broader finance recruiting timeline, as the funds seek to recruit from the same pool of students as investment banks. Because of this, expect postings to open for most funds in the winter of sophomore year, either concurrently with the major investment banks or even a few weeks before depending on location and group. There will also be other opportunities to recruit full-time in senior year depending on idiosyncratic factors (whether a firm is expanding AUM into a particular strategy and needs more headcount, performance of the prior intern class and return offers accepted, etc.) For smaller private credit funds, the timeline may be more flexible and alter on a by-need basis. The best strategy is to begin outreach during the summer following first year to learn whether they have an internship program and the specific recruiting timeline they run.

For the broader private credit recruiting scene, the later months of summer following first year is a good time to begin sending networking outreach emails. The first three weeks of September in particular is the best time. Students are back on campus at semester system colleges and will be doing networking calls with their alumni, which in turn encourages UChicago alumni to begin taking networking calls, even if the fall term hasn't begun yet. For most buy-side roles, including private credit, students shouldn't limit their networking outreach solely to analysts or associates; more senior employees don't receive as much networking inbound requests and will also have more "pull" in the interview process.

What Do I Need to Know / Prepare For?

The knowledge you should prepare for interviews in private credit can be bucketed into four main categories: “table-stakes” finance knowledge, credit-specific investment acumen, an understanding of the macro, and an understanding of several fund-specific deals.

1. The table-stakes:

- a. All the corporate finance technicals required for investment banking interviews are table-stakes for most buy-side roles. This private credit-specific guide will not delve into exactly what to prepare across this domain; there is an excess of information and guides existing on the subject.

2. Credit-specific investment acumen:

- a. This can be divided into two areas: a qualitative understanding of how to think about credit investing, and quantitative technicals related to credit investing. Typically, earlier interview rounds may ask questions related to each of these halves separately. You will also most likely encounter “investment cases” where you will combine both of these skills together. This section of the guide will use the investment case framework as a way to cover both types of material. You will come across many different variations of credit investing frameworks, and there is no one correct answer. Given the importance of this section, this guide will explore one example in the final segment.

3. Macro understanding

- a. Understand the history of the private credit asset class as described earlier in the guide. Deeply understand what the broader economy, the credit markets, and the private credit markets have been doing over the past 10, 3, and 1 years. Hold a strong position on how each of these markets will move going forward.

4. Deal-specific knowledge

- a. Understand at least 3 investments in the fund, ideally originated over the past two years. If there are any public quantitative facts related to the investment (business enterprise value, earnings figures, value of the debt, structure of the debt, spread, etc.), know them. Try to replicate the “What Makes a Good Credit Investment” framework discussed later in the guide. Try to understand how the investors thought about the deal. Most likely, you will encounter some

uncertainties/unknowns by going through this process, which you can ask about if there is a natural opportunity to do so.

What Makes a Good Credit Investment?

Fundamentally, credit investing can be framed as asking two questions, which can each be then split into further questions and analyses.

1. What kind of capital structure is appropriate for the fundamentals and financials of this business?
 - a. Probe for details around the qualitative aspects of the business model. Always try to understand how defensible the earnings of the business are under different scenarios.
 - b. Gain as much clarity and detail as possible regarding the financials of the business. You should always be digging to understand two points:
 - i. Solvency: The total enterprise value of the business should be well in excess of the debt held under different scenarios. Understand how to calculate and interpret loan-to-value (LTV), attach/detach points, equity buffer, net debt / EBITDA (leverage), etc. You should be familiar enough with these terms that you can easily derive one of these figures when given others. For example, if you know that net debt / EBITDA is 3x, and you know that the business trades at 6x EBITDA, you should realize that the LTV is 50%.
 - ii. Liquidity: The ability of the business to generate enough cash flows to make sure interest payments are covered in excess under different scenarios. Understand how to calculate the interest coverage ratio, fixed charge coverage ratio, debt service coverage ratio, and other similar variants. Note that often, any given “ratio” can have various definitions / methods to be calculated. You should know each different method and when one might be used over another.
2. Can we structure a credit investment in such a way that we are adequately rewarded for the level of risk we are taking on?

- a. Understand how the investment is being structured and pair this information with the information you've put together when answering question 1.
- b. Identify how else you could structure the investment in a way to further protect the downside, such as through covenants.
- c. Form a view on how risky / how well protected the lender is, benchmark this level of risk against your understanding of current market conditions, and describe what you'd expect the given level of return you would need to be.

Now, let's apply this framework with a mock case. These cases often begin with very broad pieces of information. You are then expected to lead the interviewer through your diligence process, which you should structure similarly to the framework previously discussed. For example, you may be told that "an air conditioning installation and repairs business" has come across your desk seeking a private credit loan.

Let's first recall the first question in our framework:

1. What kind of capital structure is appropriate for the fundamentals and financials of this business?

Here are two example questions you should ask immediately before proceeding to any sort of financial/quantitative probing:

1. What is the split between installation and repairs?

Installations are likely to depend more on economic expansion (such as new homes or new malls being built) and are therefore less "credit-worthy". Repairs likely provide a much more defensible source of revenue in any economic condition.

2. What is the average lifecycle of air conditioning systems?

A shorter lifecycle implies smoother and more reliable revenue from the repairs segment.

3. What are the geographical segments of the business?

Hotter regions are more likely to provide defensible and "stickier" revenue as repairs and installations are more critical.

After discussing these points with the interviewer, they are likely to begin giving you quantitative information regarding the financials. This information is often given to you in

separate pieces, and you are tasked with understanding how to extract other pieces of information from them. An extremely streamlined example may be that you are told “the business is currently generating \$100 million in revenue every year”.

Again, you should always want to assess solvency and liquidity. The most valuable metric for solvency is enterprise value, which will allow you to come to loan-to-value, debt-to-equity, and a host of other metrics. For liquidity, you will need either unlevered free cash flow, or the closest equivalent you can reach given the information you’ve been provided with.

In our example, you will likely be able to gain more information about costs to the point where you can reach a “useful” earnings metric. For example, you may conclude that EBITDA is at \$20 million.

From there, you should understand general trading dynamics of different types of businesses. For an HVAC business, you might assume that it trades at roughly 6x EBITDA. This informs us that the EV of the business is \$120 million. From here, there are quite a few useful observations you could draw. For example:

1. We ideally want LTV around 50% at most. If we are the sole unitranche lender, this implies the maximum face value of the loan should be \$60 million.
2. We can then state that for this sort of business, a typical spread in today’s credit market could be SOFR + 550. If we assume SOFR to be around 400-450 bps, this implies an all-in rate of around 10% today. 10% of the face value of the loan at \$60 million gives us \$6 million of incremental interest expense.
3. We want interest coverage to be at least 2x. If we use the EBIT / Interest Expense definition, we can assume a certain level of depreciation and amortization to reach an EBIT assumption of \$25 million. This implies the maximum interest expense is around \$12.5 million. At just \$6 million, we are more than 4x covered.

If the analysis above is approved by the interviewer, we can then move on to assessing how else we could strengthen our protection as a lender on this loan before making our final investment decision. In this case, we would likely ask for details on what sorts of covenants the borrower is willing to agree to. Such covenants should include:

1. Maintenance covenants (tested on an ongoing basis) include leverage ratios, interest coverage ratios, FCCR, liquidity above a certain level.
2. Incurrence covenants (tested when the borrower wants to do a specific action) include debt incurrence tests (no additional debt unless pro forma leverage passes a certain threshold), restricted payments test (no dividends/buybacks unless certain tests are met), and more.

We can also ask what sorts of hard assets our debt could be collateralized against to further strengthen our position. If this is sponsor-backed, evaluate whether the sponsor has been “lender-friendly” in the past. For example, are they committed or are they likely to try to take their equity out in a rough situation (which would wholly remove our equity buffer)?

Finally, deliver your assessment on whether you would make this credit investment given all the information you’ve put together over the last 30 minutes or so. Your answer should always depend on current market conditions (down to the last 6 months). Always think about whether this is an attractive investment given what sort of return you could otherwise access at this level of risk (or what level of risk you could otherwise bear to achieve the same return).