CHIEF INVESTMENT OFFICE

Alternative Investments Insights

Private Credit on the March

September 2023

All data, projections and opinions are as of the date of this report and subject to change.

SUMMARY

- Private Credit has been in the spotlight, with significant attention and interest from investors, asset managers and the financial press. The asset class has grown rapidly to $1.5 trillion, with its share of the leveraged finance market expanding to approximately 30% today.[1] Private Credit providers have also been aggressively stepping into a void left by the recent retreat of lenders in the public leveraged credit markets. With structural tailwinds at its back, we believe Private Credit is poised to continue its absolute and relative growth as a major player in leveraged finance.

- The opportunity set for fresh capital also looks attractive from a cyclical perspective. Yields have climbed to low to mid teens. The likelihood of a recession has diminished, incrementally reducing credit risk. Existing portfolios may be challenged by the increased interest expense burden on underlying borrowers.

- Situated higher in the capital structure, Private Credit may provide a more defensive posture compared to areas such as Private Equity and Private Real Estate, where investor concerns about valuations remain. Investors should note, however, that while it is a "yielding" asset class, Private Credit is more closely associated with Equity risk factors. As such, Private Credit can play a role in a portfolio by virtue of its risk-adjusted returns and potential for greater income generation; however, investors should be mindful equating it to the higher-quality segments of Traditional Fixed Income (e.g., Treasurys).

AUTHORED BY:

Chief Investment Office

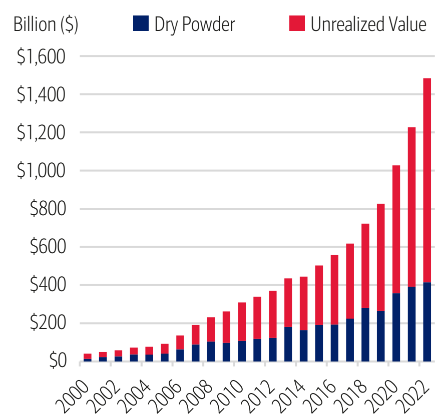
Data as of August 30, 2023 and subject to change.

LANDSCAPE AND ATTRIBUTES

Private Credit is a catch-all term that refers to debt instruments or obligations—including loans, bonds or otherwise—issued by private entities in private offerings. The asset class has grown rapidly in recent years to approximately $1.5 trillion by the end of 2022 (Exhibit 1). Private Credit now rivals the broadly syndicated leveraged loans asset class and is roughly two-thirds the size of global high-yield bonds (Exhibit 2).

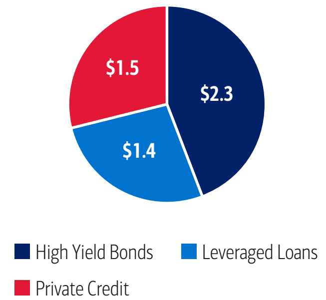
There is no standard definition, though, of precisely what it encompasses, and the reality is that the universe of Private Credit strategies has evolved over time. Strategies that

Exhibit 1. Private Credit Assets Under Management.



Source: Preqin. As of December 31, 2022.

Exhibit 2. Leveraged Credit Market Size ($ trillions).



Sources: BofA Global Research, Preqin.
As of May 26, 2023.

[1] See Exhibit 1 and 2 for sources.

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today are broadly considered to fall within that universe include, but are not necessarily limited to:

- Direct Lending
- Mezzanine
- Special Situations/Distressed
- Asset-based Finance
- Real Estate Debt
- Infrastructure Debt
- Venture Debt

At a high level, Private Credit is characterized by certain structural features. One is that Private Credit is largely constituted by floating-rate debt. Thus, returns generally increase as interest rates rise, and vice versa, in contrast to fixed rate bonds. Another feature is that it is largely illiquid. Its illiquidity in turn means that investors should view the asset class from the perspective of a strategic allocation within a portfolio, and that Private Credit fund managers should offer limited or infrequent redemption terms to match the duration of the underlying investments. Private Credit's illiquidity has also historically generated a "premium" to public credit in the form of higher returns and/or yield as compensation for the increased liquidity risk.

Other attributes of Private Credit depend on the specific strategy or subasset class. Direct Lending, for instance, is generally comprised of private loans to corporate borrowers that are senior in the capital structure, often collateralized by hard assets, with meaningful covenants. Much of Direct Lending today is conducted between non-bank "alternative" lenders and private companies that are "backed" (owned) by Private Equity sponsors.

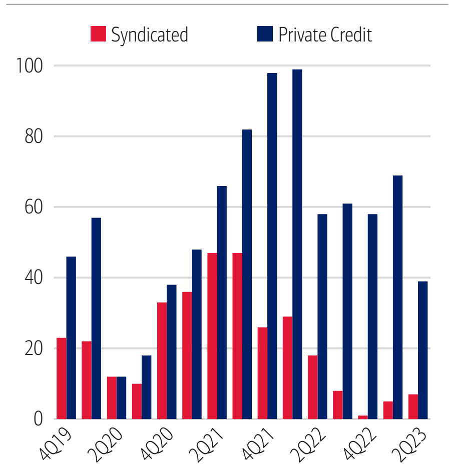
TRENDS AND THEMES

Private Credit has grown due to a range of factors. Given the typically higher cost of private debt, the motivations of borrowers are important to consider. Historically, borrowers were assumed to tap private markets simply because they could not otherwise access the more liquid, lower-cost public markets. While still true to a degree, borrowers today increasingly prefer to borrow from private markets. According to surveys from PitchBook LCD, the primary reasons driving borrowers to fund in Private Credit markets over broadly syndicated leveraged loan markets are: 1) execution/pricing certainty and 2) speed. The nature of Private Credit markets is such that pricing is locked in once terms are set and does not change due to market conditions before closing. In addition, these markets are generally characterized by faster execution and higher certainty of closing.

Regardless of the motivations of borrowers, Private Credit has been taking market share from other lender types. As previously suggested, this has been part of a nearly two-decade trend; and yet more recently we have seen an amplification of this dynamic over the last two years. The combination of rising interest rates and the regional banking crisis sparked by the Silicon Valley Bank (SVB) has led to a major (if temporary) retrenchment of banks and other institutional high-yield and leveraged loan lenders. As shown in Exhibit 3, the second half of 2022 and the first half of 2023 saw Private Credit finance nearly the entire volume of leveraged buyouts (LBOs), while broadly syndicated leveraged loan markets dried up altogether. Public credit markets will not remain closed forever. However, the evidence continues to point in favor of Private Credit's absolute and relative expansion.

Some other trends within the space are also worth noting. In the wake of the SVB collapse, we have observed Private Credit managers shoring up strained regional banks, acquiring loan portfolios or lending alongside the banks in areas like home improvement and auto finance. Private Credit has even been making a push into Investment-grade lending, which could increase competition between Alternative and Traditional lenders across the entire credit spectrum.

Exhibit 3. LBOs Financed with Public versus Private Credit Markets.



Source: PitchBook LCD. As of June 30, 2023.

PERFORMANCE AND POTENTIAL OPPORTUNITIES

Like other private markets strategies, Private Credit has performed well historically (Exhibit 4). Using Cambridge Associates data, Private Credit handily outperformed public high-yield and leveraged loan indexes on both 10- and 20-year bases. Over the 20-year window, Private Credit outperformed high yield by 248 basis points (bps) and leveraged loans by 486 bps, using public markets equivalent (PME) methodology. Private Credit outperformed high yield and leveraged loans by 450 bps each over the shorter 10-year lookback.

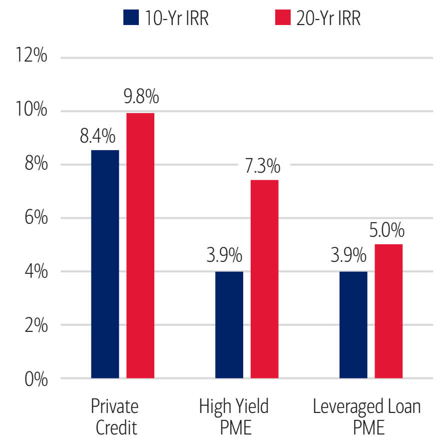
Investors should note that private markets strategies tend to have significantly wider ranges of reported performance compared to investment strategies in public or Traditional asset classes. For instance, when looking at the past 20 years of performance, the top quartile of Private Credit funds generated annualized returns of 13.3%, whereas the bottom quartile generated returns of 5.7%, according to Cambridge Associates. The wide range of performance outcomes across private markets in general, and Private Credit specifically, reinforces two things, in our view: 1) potential opportunity and 2) the importance of diversification. There is opportunity to enhance returns through manager selection; by the same token, investors would be wise to seek diversification across managers, strategies and vintage years.

The opportunity set today looks compelling for fresh capital. Driven by the increase in policy rates set by the Federal Reserve (Fed), yields in Private Credit have risen to the low to mid teens. Direct Lending yields, for example, have reached 12.1% compared to 10.0% for the broadly syndicated leveraged loan market.[2] Anecdotally, other areas within the Private Credit universe have been offering even higher yields. The lower duration (sensitivity to interest rate moves) of Private Credit have also been attractive in this recent environment. Lastly, lending strategies have stood out in the last couple years within the broader universe of Alternatives where valuation concerns are higher including in Private Equity and Private Real Estate.

Investors are also, in many cases, still smarting from recent challenges in Traditional Fixed Income in recent years. In 2022, Traditional Fixed Income, as measured by the Bloomberg U.S. Aggregate Bond Index, returned -13.0% at the same time that the S&P 500 returned -18%. After a slight reprieve in January through March of this year, Treasury yields have once again been on the march higher from April onwards. As has been much commented, this new macro regime of higher interest rates and inflation has altered the relationship between stocks and bonds. The correlation between the performance of these two foundational asset classes has jumped to approximately positive 0.7 after a relatively long stretch of negative (albeit volatile) correlations (Exhibit 5).

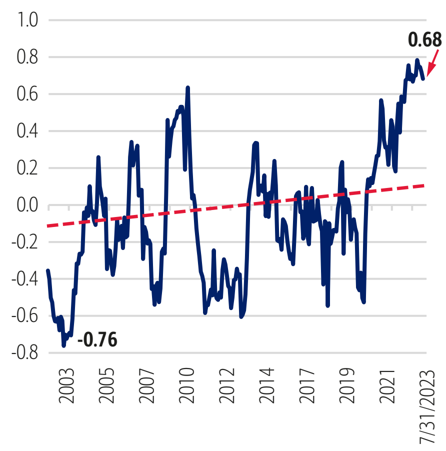
The Chief Investment Office's view is that the recent relationship is likely to revert. Real yields in Fixed Income are also more attractive today than during the decade-plus period following the 2008/2009 Global Financial Crises. With a slowing (if resilient) economy, slowing inflation, and the expectation that 10-year Treasury yields may decline into next year, the outlook for Fixed Income is more constructive than at the beginning of 2022. However, a surprise re-acceleration of inflation could resurface last year's dynamics, potentially challenging long duration and inflation-sensitive asset classes. In that context, Private Credit has the potential to be a useful complement to Traditional Fixed Income by virtue of its lower-volatility profile and lower-interest-rate sensitivity. Again, investors should note that while the lower-duration profile of Private Credit might be appealing in such an environment, the tradeoff is higher credit risk, which in turn, could add to the equity risk of a portfolio. The question is whether investors are compensated for that risk.

Exhibit 4. Private Credit Internal Rate of Return (IRR) versus Public Credit.



Source: Cambridge Associates, as of 1Q23. High Yield PME (public market equivalent) represented by the ICE BofA U.S. High Yield Master II Index. Leveraged Loan PME represented by the Credit Suisse Leveraged Loan Index. **Past performance is no guarantee of future results. Please refer to index definitions at the end of this report. It is not possible to invest directly in an index.**

Exhibit 5. Correlation Between Bonds and Equities.



Source: Bloomberg. Bonds represented by Bloomberg U.S. Aggregate Bond Index; Equities represented by S&P 500 Index. Rolling 12-mo correlation uses monthly total returns.12/31/2001 - 7/31/2023. **Past performance is no guarantee of future results. Please refer to index definitions at the end of this report. It is not possible to invest directly in an index.**

[2] Bloomberg, Cliffwater. As of June 30, 2023. Broadly syndicated leveraged loan yields represented by the yield-to-maturity of the Credit Suisse Leveraged Loan Index. Direct Lending yields represented by the 3-year takeout yield of the Cliffwater Direct Lending Index (CDLI).

RISK CONSIDERATIONS

So, what are the risks associated with Private Credit? The primary fundamental risk is right there in the name: "credit." Credit risk itself comprises separate but related component risks: default and recovery. Default risk is the probability of a borrower missing a contractually obligated interest or principal payment, whereas recovery risk is the potential loss of principal because of a default. Historically, Direct Lending strategies have registered average annual loss rates of 0.15% for senior loans and 1.03% looking at a broader set of middle market loans.[3]

The current cycle poses conflicting signals for Private Credit. On the one hand, the probability of a recession in the near term has been declining, with many analysts now expecting to skirt a recession altogether this year and next. On the other hand, higher interest costs—by virtue of Private Credit's floating-rate nature—has reduced companies' interest coverage ratios, particularly for the lowest-quality segment of borrowers. Sustained high interest rates could create significant pressure, ultimately leading to increased default and loss rates. Real earnings growth will be required to offset the pressures of both higher interest rates and higher inflation should they persist.

Potentially mitigating the risk of increased defaults is the fact that debt maturities have been pushed back, as companies and Private Equity sponsors took advantage of the low-rate environment with significant refinancing activity in 2020-2021. Furthermore, BofA Global Research estimates that defaults for broadly syndicated leveraged loans will finish the year around 3% and expects Private Credit to largely rise in line with them. Private loans are also known to have stronger financial covenants relative to public markets, which can help address credit issues earlier. Lastly, Private Credit can often feature payment-in-kind (PIK) and other similar mechanisms, which may allow a borrower to pay interest with additional debt or Equity instead of cash. Investors have differing views on whether PIKs increase long-term risk, but in the short term they can relieve cash flow pressures on borrowers.

ADDITIONAL RISKS INVESTORS SHOULD CONSIDER

- Liquidity—As previously mentioned, Private Credit should be considered illiquid and viewed as a long-term strategic allocation.
- Potential conflicts of interest—With Alternative managers (often the same ones) playing the roles of lender to and owner of the borrower, conflicts of interest need to be carefully assessed and managed.
- Capital flows—The flipside of Private Credit's success is that significant amounts of capital have flowed into the space. Investors should track whether that supply of capital compresses Private Credit returns relative to public credit alternatives.

CONCLUSION

Ultimately, Private Credit will likely continue to expand and mature as an asset class. At the same time, suggestions that it will replace public leveraged credit markets altogether are farfetched. We expect ebbs and flows between Private Credit and public credit based on the macroenvironment and the relative utility to borrowers. As always, regulation will also play a role in shaping both public and Private Credit markets.

Beyond the upsides (higher yields; lower duration) and downsides (slowing economic growth; higher debt service burdens for borrowers) for Private Credit in the current environment, qualified investors should consider this growing asset class as one more tool in their portfolio toolkit.

[3] Cliffwater. As of June 30, 2023. Senior loan loss rates measured by the Cliffwater Direct Lending Index: Senior-Only (CDLI-S) from inception in September 2010 through 3/31/2023. Directly originated middle market loan loss rates measured by the Cliffwater Direct Lending Index (CDLI) from inception in September 2004.

Asset Class Proxies and Index Definitions

The indices defined below are unmanaged, include the reinvestment of dividends when applicable, do not reflect the impact of transaction fees, management fees, or incentive compensation, and are not available for investment. They are included here for illustrative purposes.

S&P 500 widely regarded as the best single gauge of the U.S. equities market, includes a representative sample of 500 leading companies in leading industries of the U.S. economy.

Private Credit/Cambridge Associates Private Credit Index is a horizon calculation based on data compiled from 461 credit opportunities (i.e. general credit opps and distressed), subordinated capital (i.e. mezzand capital appreciation opps), and senior debt (i.e. direct lending) funds, including fully liquidated partnerships, formed between 1986 and 2018.

ICE BofA High Yield Master II Index tracks the performance of U.S. Dollar-denominated below investment- grade corporate debt publicly issued in the U.S. domestic market.

Cliffwater Direct Lending Index seeks to measure the unlevered, gross of fee performance of U.S. middle market corporate loans, as represented by the asset-weighted performance of the underlying assets of Business Development Companies (BDCs), including both exchange-traded and unlisted BDCs, subject to certain eligibility requirements.

Credit Suisse Leveraged Loan Index tracks the investable market of the U.S. dollar denominated leveraged loan market.

U.S. Municipal High Yield/Bloomberg High Yield Municipal Index is a benchmark that covers the high yield portion of the USD-denominated long-term tax exempt bond market. The index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds, and pre-refunded bonds.

Leveraged Loans/Morningstar LSTA US Leveraged Loan Index is designed to measure the performance of the 100 largest facilities in the US leveraged loan market.

Bloomberg U.S. Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market.

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Asset allocation, diversification and rebalancing do not ensure a profit or protect against loss in declining markets.

Public Market Equivalent (PME) analysis enables comparison of private investment performance against public markets, providing context on what performance would have been had the private investment cash flows been subject to public benchmark returns.

Investments have varying degrees of risk. Some of the risks involved with equity securities include the possibility that the value of the stocks may fluctuate in response to events specific to the companies or markets, as well as economic, political or social events in the U.S. or abroad. Investing in fixed-income securities may involve certain risks, including the credit quality of individual issuers, possible prepayments, market or economic developments and yields and share price fluctuations due to changes in interest rates. Investments in high-yield bonds ("junk bonds") may be subject to greater market fluctuations and risk of loss of income and principal than securities in higher rated categories. Bonds are subject to interest rate, inflation and credit risks. Investments in high-yield bonds (sometimes referred to as "junk bonds") offer the potential for high current income and attractive total return, but involves certain risks. Changes in economic conditions or other circumstances may adversely affect a junk bond issuer's ability to make principal and interest payments. Treasury bills are less volatile than longer term fixed income securities and are guaranteed as to timely payment of principal and interest by the U.S. government. Most senior/leveraged loans are made to corporations with below investment-grade credit ratings and are subject to significant credit, valuation and liquidity risk. The value of the collateral securing a loan may not be sufficient to cover the amount owed, may be found invalid or may be used to pay other outstanding obligations of the borrower under applicable law. There is also the risk that the collateral may be difficult to liquidate, or that a majority of the collateral may be illiquid. Investments in foreign securities (including ADRs) involve special risks, including foreign currency risk and the possibility of substantial volatility due to adverse political, economic or other developments. Investments in a certain industry or sector may pose additional risk due to lack of diversification and sector concentration. Investments in real estate securities can be subject to fluctuations in the value of the underlying properties, the effect of economic conditions on real estate values, changes in interest rates, and risk related to renting properties, such as rental defaults.