INVESTING THROUGH MARKET CYCLES: THE ONGOING OPPORTUNITY IN PRIVATE CREDIT

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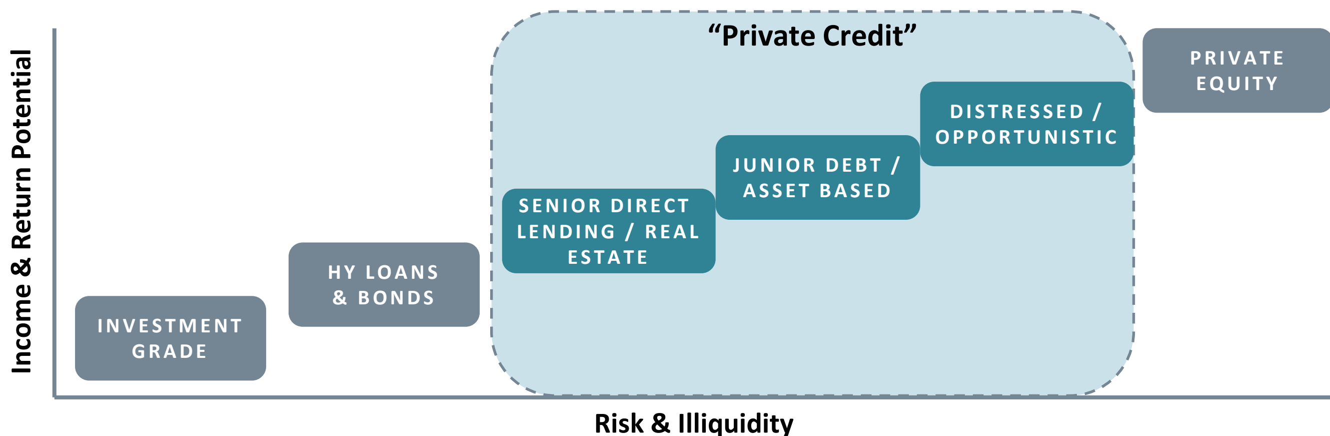
THE ONGOING OPPORTUNITY IN PRIVATE CREDIT

Considerations While Navigating a Growing Asset Class

The private credit industry has offered investors attractive yields and total returns over the last fifteen years (and longer for those early to the asset class), as a secular shift in the lending market created an opportunity for investors to benefit from the elevated spreads and yields available in this market. Over the last two decades, traditional sources of capital (banks) have stepped back from middle market lending, and asset management firms have stepped in. As tends to happen, the attractive returns being delivered from private credit by these asset managers attracted attention and investors of many types have flocked to this asset class. Over the past 15 years, the private credit asset class has delivered annualized returns of 10.1% compared to 8.6% for high yield and 1.8% for investment grade bonds[1]. The private credit industry has grown to become the second largest asset class in the global alternatives market according to Pitchbook[2], behind private equity. The pace of growth in this market has been relatively quick, evidenced by the asset class reaching an estimated $1.6 trillion in total assets under management as of June 2024, from $357 million at the end of 2010[2]. We believe growth in the private credit industry is well supported, but recent growth has led to a great deal of skepticism and to questions of whether the industry has grown too large, and too fast. In this paper we reflect on the history of this asset class, the opportunity going forward for investors in private credit, and important considerations for investors as they navigate this market. We believe incorporating private credit in a well-diversified portfolio remains a compelling investment proposition; however, investors need to be discerning about strategy and manager selection as they consider private credit in this more mature phase of the industry's growth.

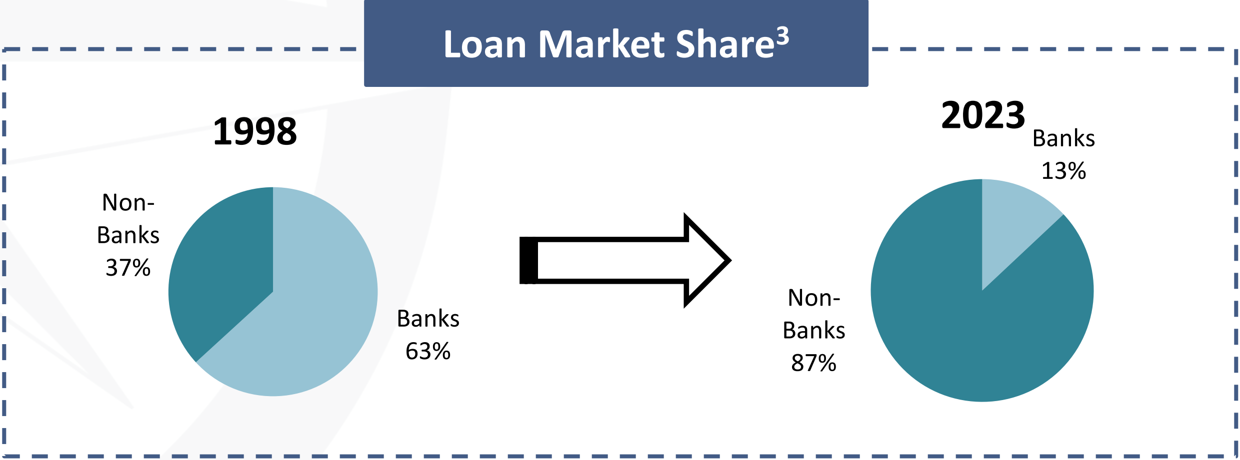
The Private Credit Industry: A Brief History

Private credit is generally defined as lending by non-bank financial institutions to private companies. Direct lending, or senior debt financing that is directly originated by an asset manager for a middle market corporate borrower, is one type of private credit and the largest category in the asset class today, approximately ~55% of private credit's total assets under management[2]. Direct lending is often referenced interchangeably with the broader asset class, but today investors have a number of choices in private credit, with varying risk characteristics, return opportunities, and borrower types, as evidenced in the exhibit below.



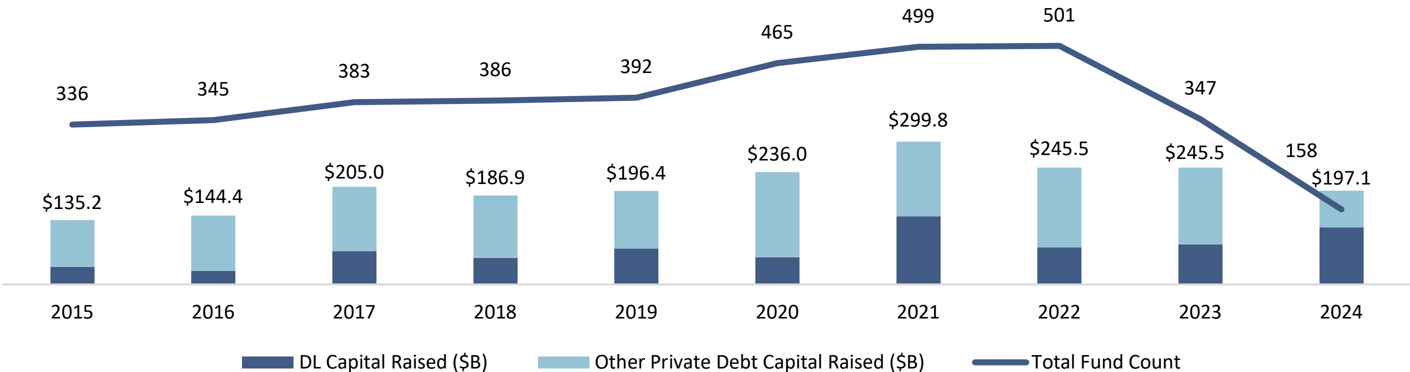
Source: [1]AAM The Rise of Private Credit December 2024, [2]Pitchbook, 1H 2024 Global Private Debt Report

As referenced, the vast majority of the industry's growth has occurred over the last fifteen years as regulatory reform following the Great Financial Crisis resulted in many banks pulling back or stepping away from lending, most significantly to the middle market (generally defined as companies with between $25 and $100 million of EBITDA). Asset managers stepped in to fill the void and have become the primary source of credit to the private sector. The chart below demonstrates how this shift away from banks has occurred over time in the U.S., to a new paradigm that has persisted in recent years. We believe this secular shift and the new lending environment will persist, in particular in the middle market, and one important reason is that borrowers found this change in the lending market to be favorable. Private companies and their owners prefer the certainty and speed of execution offered by asset managers. In the sponsor-backed lending market, where borrowers are owned by private equity firms, we often hear that that private equity owners prefer to work with non-bank lenders who are more aligned with business owners, have permanent sources of capital, and who are often willing to work with the management team and the owner when a borrower goes through a challenging period[3].



Amidst this shift in the source of capital, investors have continued to support the growth of the private credit industry. Non-bank lenders generally have to raise capital to support investment activities and investors have stepped up to the plate, with record fundraising results for private credit funds, as summarized in the chart below from Pitchbook[4]. Investors have been attracted to the floating rate characteristic of these loans to reduce interest rate sensitivity in their portfolios, and to the higher spreads (illiquidity premium) found in private credit. A period of low default rates has further supported institutional and retail and institutional dollars flowing into private credit funds.

Direct Lending Fundraising Activity[4]

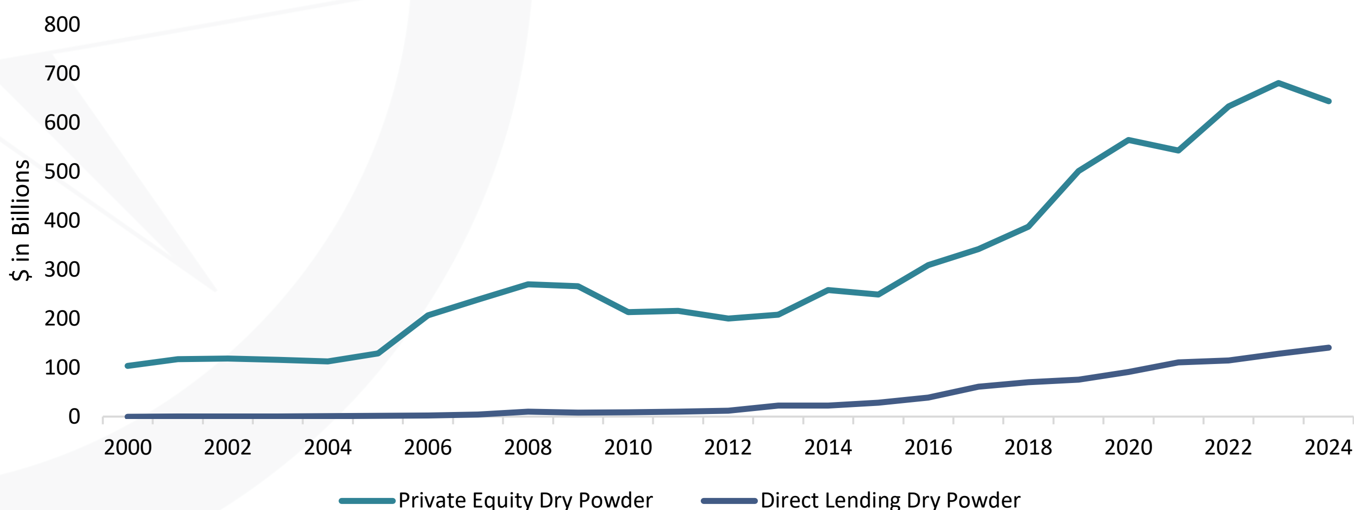


Source: [3]Federal Reserve Bank of St Louis, [4]Pitchbook 2024 Annual Global Private Debt Report

The Opportunity in Private Credit

As we look ahead, the private credit industry continues to offer an attractive investment opportunity, although investors will need to be discerning in their allocation decisions in this next stage of growth. Amidst some negative headlines and the suggestion that recent growth in the industry looks like a bubble, there is a strong argument that the growth of private credit is well supported, and skeptics may not be considering the bigger picture. One important consideration is to compare the dry powder, or capital raised but not yet deployed, in the private credit industry to levels in the private equity industry, as illustrated in the chart below from Preqin. As private equity sponsors invest that dry powder in new deals, they will look to the private credit market to fund the debt portion of those deals, generally at a level around 50% of total deal value. When we make this comparison, the private credit industry actually looks undercapitalized today, and an argument can be made that further asset growth in the industry is supported, particularly as deal activity across private markets is expected to pick up in the months ahead.

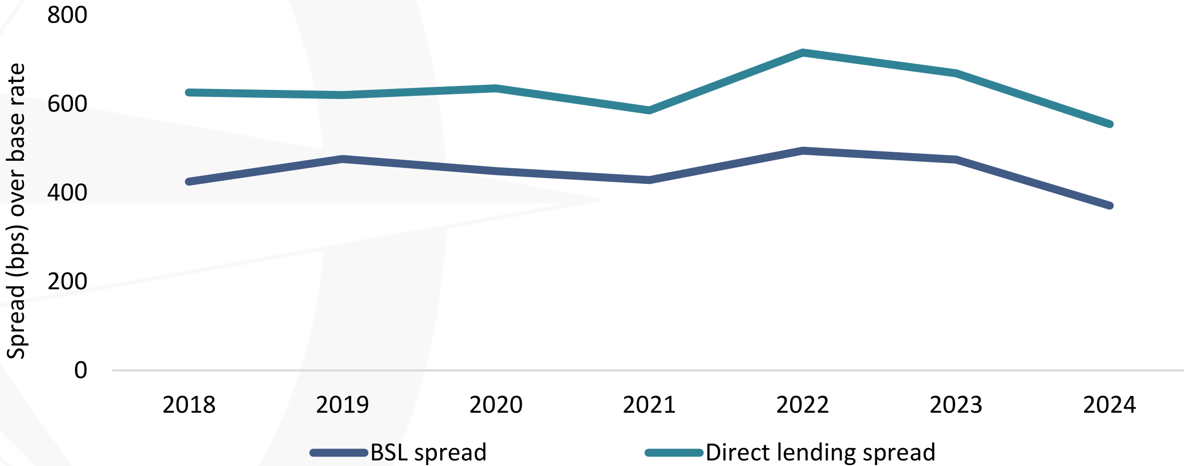
Private Market's Dry Powder is Still Near Record High[5]



As we contemplate where the private credit industry goes from here, the role of the traditional capital provider also comes back into play. A new administration in the U.S. and the related possibility of a change in banking regulations and reduced capital requirements mean that a resurgence of competition from banks is a possibility. We believe this dynamic will have the largest impact on the broadly syndicated loan (BSL) market, or the upper end of the private market, where banks have recently been competing for more deals and driving spreads lower in larger transactions. We expect increased lending activity by banks to have less of an impact on the middle market, and we also refer back to the earlier comments on the preference of borrowers for speed and certainty of execution provided by asset managers. We have heard many anecdotes of middle market private equity sponsors accepting a deal with a higher spread to prioritize partnering with a lender who is considered to be a stronger partner, over the deal with the most aggressive terms.

Source: [5]Preqin, as of July 2024.

This sets the stage for a continued investment opportunity for investors of many types. The elevated yields and returns, or the "illiquidity premium" previously referenced, has been a consistent and important part of the investment proposition in this asset class. The yield and total return potential delivered through private credit investments will vary based on the strategy, the type of underlying credit risk, and the vintage. Investors have choices in the risk they are willing to take in search of higher returns, but the delivery of a premium in exchange for giving up some liquidity and making a longer-term investment has been consistent. As context, the chart below[6] shows historical spreads in the direct lending market as compared to the broader syndicated loan market, and while absolute levels of spreads change over time with the broader market environment, the premium remains.



Higher returns have been delivered with attractive risk characteristics as well. The opportunity to earn higher spreads relative to public loan markets is a function of giving up liquidity, not necessarily taking on more credit risk. One way to consider this point is to look at comparative default and loss rates.

Over time, default rates in middle market direct lending have been indicated to be lower than in the broadly syndicated loan market, and recovery rates on defaulted loans have also been higher. Standard & Poor's data shows that the average nominal recovery rate on first lien term loans was 87% for loans in the middle market (<$350mm of debt), and only 74% for loans to larger companies (>$350mm of debt)[7]. The return of principal is an important component of the total return equation in private credit. In private credit, alpha can be generated through loss avoidance, and this history provides some comforting perspective on the risks that investors are taking when stepping into the private credit market. Not all risks are created equal of course, and earning higher returns with lower loss rates requires skill and experience. With this in mind, manager selection, and evaluating a firm's skill in credit underwriting, is critical in benefitting from this asset class, as we will review in the next section.

Private credit can also offer benefits to portfolios beyond a return premium. Through adding an allocation to private credit, an investor is receiving exposure to the universe of private companies, and diversifying sources of company and industry exposure in their portfolio. The growth of this industry has also included the expansion of borrower type and underlying credit risk, with more recent growth in asset backed lending, further enhancing diversification benefits. The asset backed market provides exposure to a range

Source: [6]Source: Pitchbook, LCD, as of 12/31/24., [7]S&P Global Ratings Research &Insights, as of 9/30/23, for the period 1987-2023.

of underlying collateral, including consumer and auto loans, mortgages, credit cards and even royalty streams in more niche strategies, potentially reducing a portfolio's sensitivity to business cycles and corporate M&A activity.

Navigating the Private Credit Landscape Today

To take advantage of the return opportunity in private credit and bring the benefits of this asset class to their portfolios, investors have many choices today across managers, strategies, fund structures, and risk and return. However, as is true in private equity, we believe that in private credit not all firms and funds are created equal. Manager selection is paramount. The dispersion of returns amongst funds in private credit has not been as historically wide in private credit as compared to private equity. However, we believe that over a full cycle, and particularly in periods of dislocation including slower growth and rising default rates, prudent manager selection will be imperative as more experienced firms with more stringent and consistent underwriting standards will outperform. Tariffs and the potential for a global trade war have led to uncertainty and could present risks to economic growth. We believe the U.S. middle market will generally be less exposed to direct impacts from tariffs, given these businesses largely manufacture goods or provide services domestically for a largely U.S. customer base. Further, middle market businesses have been adapting for the headwinds of supply chain disruptions and higher costs for several years. This is not to say that these borrowers may not be impacted from the risks of slowing GDP growth and dampened business activity, however the senior direct lending strategy, at the top of the capital structure and with the attractive LTV (loan-to-value) levels that the market has pricing lately provide some comfort in today's market backdrop. For example, a senior direct loan at 40% LTV means that the borrower's enterprise value can decline 60% before the loan takes a loss. Further, and most importantly, the skill and experience that a lender has in partnering with sponsors and management teams to navigate companies through challenging periods will be important to realizing long-term return expectations from a private credit allocation, if the risks to growth become heightened.

Investors can benefit from critically evaluating managers to understand and consider:

- Experience and a track record investing through market cycles, including periods of recession;
- Strength and consistency of the credit underwriting process;
- The advantages held by leading lenders over syndicate participants in regards to ability to establish favorable terms and control outcomes in periods of distress; and
- Existence of workout teams as a core part of the investment team, and belief in the long-term value of workout teams to play a critical role in return of principal.

The private credit market offers a rich opportunity set to investors today and through market cycles. Like so many other investment decisions, investors can benefit from an advisor and partner in the manager selection process to help drive results that maximize the opportunity available in this still nascent and growing investment landscape.

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