Private Credit

An introduction to Private Credit

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- Private credit is a type of debt financing provided by non-bank lenders that is not issued or traded in an open market.
- Private credit strategies like direct lending can offer an attractive option for investors looking to generate higher yields and diversify their portfolio from traditional fixed income.
- Direct lending tends to provide more conservative risk-return profiles than leveraged loans and high yield bonds.
- For investors willing to lock up capital and commit for an extended period, direct lending offers access to an asset class with appealing enhanced yield and downside mitigation.

Source: Getty Images

What is Private Credit?

Private credit is a type of debt financing provided by non-bank lenders that is not issued or traded on an open market. Companies, usually small to mid-sized, that often cannot or choose not to access public markets for debt financing, will turn to the private markets. In a capital structure, private credit acts just like public debt, sitting below equity (Fig 1). Unlike public credit strategies (ex: high yield, investment grade debt or Treasuries), most private credit investments are offered through a private fund or through a business development company (BDC) (see **Glossary of terms**). Some private credit strategies focus on generating high yields compared to what is available in the public credit markets. Other strategies focus on capital appreciation of the underlying asset that the credit is backed by.

The main types of private credit are direct lending, mezzanine debt, venture debt, opportunistic / distressed debt and specialty financing:

- Direct lending, or senior debt, involves loans made directly from the lender to a company to support growth, acquisitions, or refinancing needs. These loans are typically senior in the capital structure, secured by collateral, and offer floating-rate coupons.

Figure 1: Illustrative capital stack

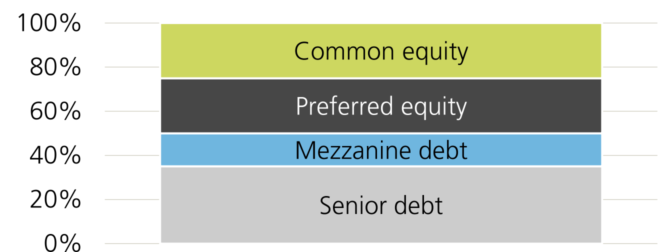
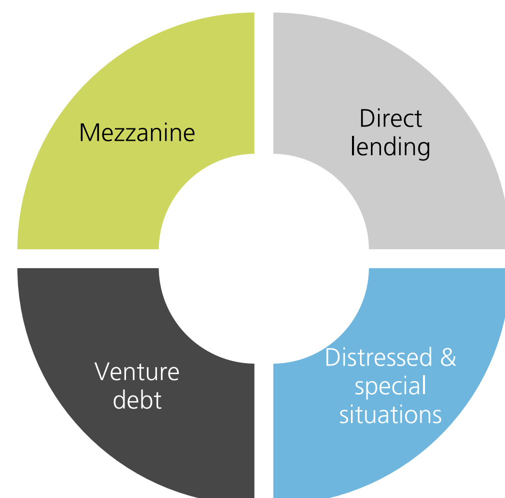


Figure 2: Main types of Private credit

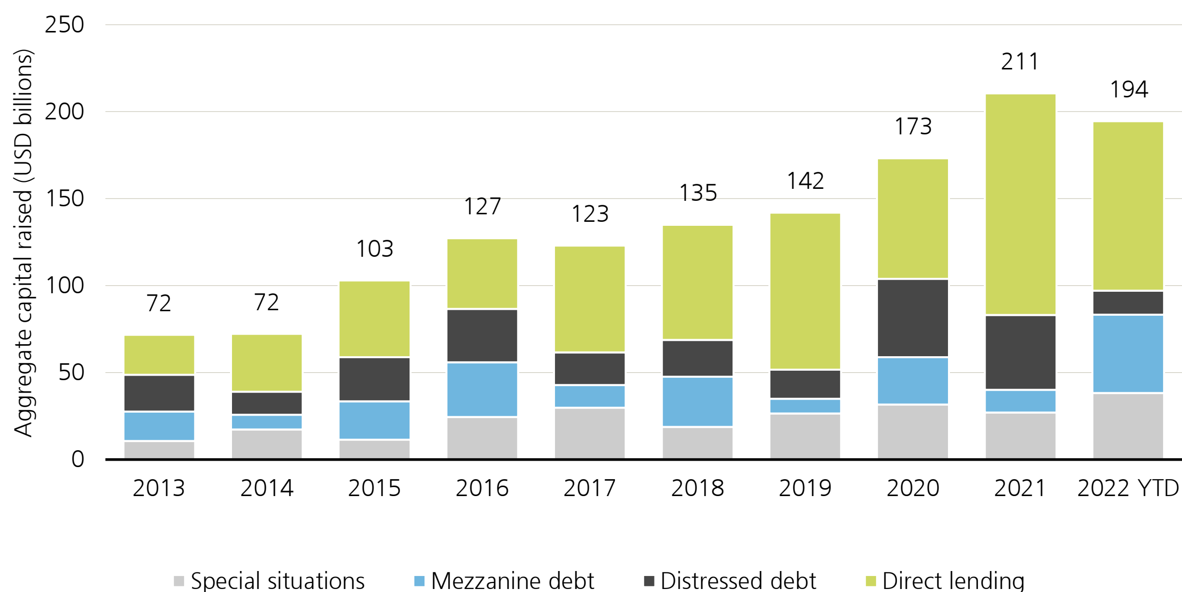


- Mezzanine debt is subordinated debt that sits between senior debt and equity, usually with embedded equity instruments attached to create upside. It carries more risk but offers higher potential returns.
- Venture debt are loans to venture capital-backed companies by a specialized financier to fund working capital or capital expenses. Venture debt combines loans with warrants or other mechanisms to purchase equity, to compensate for the higher risk of lending (Fig 4: Private Credit risk / return analysis)
- Opportunistic / distressed strategies invest in financially troubled companies at a discount, usually on the secondary market. It carries the highest risk and return potential based on a successful restructuring of the company. Specialty financing focuses on niche strategies, targeting sectors needing specialized expertise, such as music royalties, aviation financing, nonperforming loans, amongst others.

Within these categories, the private credit investments can be further differentiated and specialized. For example, other investments include CLOs, CRE, RMBS, or consumer ABS among many other specialized sub-categories. Managers can choose to be even more specialized and invest in only equity CLOs or only debt CLOs.

Private credit has grown in prominence in recent years. The Global Financial Crisis led to new banking regulations that constrained lending by banks and opened space for non-bank lenders to step in. At the same time, interest rates fell to historic lows, pushing investors to seek higher yields in private credit. As a result, assets under management in private debt strategies grew rapidly, particularly in direct lending (Fig 3). Given that direct lending makes up the bulk of AUM, this paper will focus on that strategy going forward.

Figure 3: Private credit fundraising



Source: Preqin, UBS, as of September 30, 2022

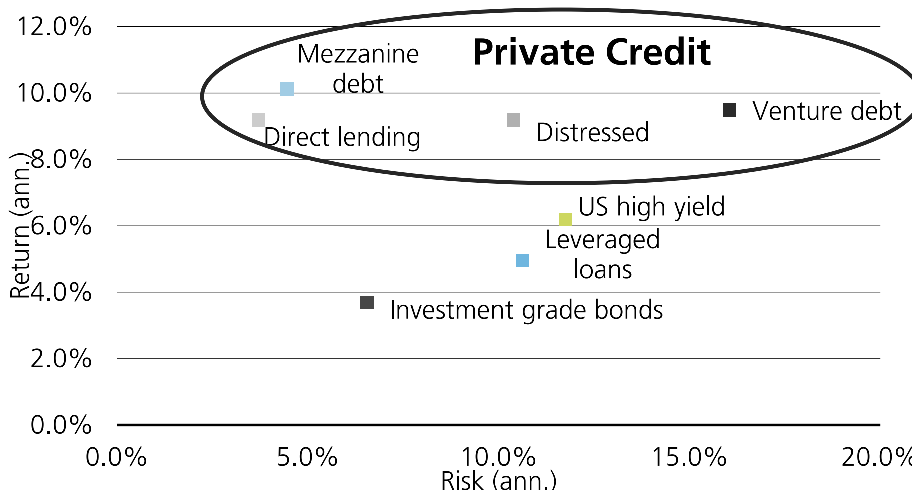
Why invest in direct lending?
Direct lending provides several benefits for investors compared to traditional fixed income. First, direct lending is usually floating rate in nature and therefore can be more attractive when interest rates are rising. Second, the private nature of direct loans and quarterly marked-to-market valuations tend to reduce price volatility when compared to traded leveraged loans or traditional fixed income. For investors, it can provide the smoother and better returns in a highly volatile market.

How to invest?
Investors can access private direct lending strategies through traditional draw-down and lock-up funds or through BDCs (either publicly traded or private). Investors should be aware of the different fee structures and liquidity profiles of the vehicle they choose.

Comparison of Private vs. Public
Direct lending differs from broadly syndicated leveraged loans in several ways. Direct loans are privately negotiated between a borrower and a lender, providing more flexibility in structuring terms such as covenants (please see side bar "What Are Debt Covenants"). This allows the lender to tailor the loan to fit the specific needs and risks of the borrower. In contrast, leveraged loans are syndicated by underwriters to a broad group of institutional investors. The underwriter structures the loan terms. Private directs loans typically have between one and six lenders and don't carry syndication risk, or the risk that the underwriters won't be able to successfully sell the loan to multiple lenders. A syndicated loan may have dozens, or as many as 200 lenders in a single transaction. Direct loans often do not need credit ratings from agencies like Moody's or S&P. Instead, the lender would need to conduct due diligence on the company's finances. Direct loans tend to have lower loan-to-value ratios, higher debt service coverage ratios, and stronger covenants. Although the terms could vary drastically from one loan to another and investors should be aware of those differences.

Due to the privately negotiated nature of direct loans, they can have faster underwriting and closing timelines compared to broadly syndicated loans; and certainty of completion, which in volatile times, borrowers place more emphasis on. Finally, private direct loans are often floating-rate instruments, which make them less sensitive to interest rates compared to fixed-rate bonds, which can lose value as interest rates rise.

Fig: 4: Private Credit risk / return analysis



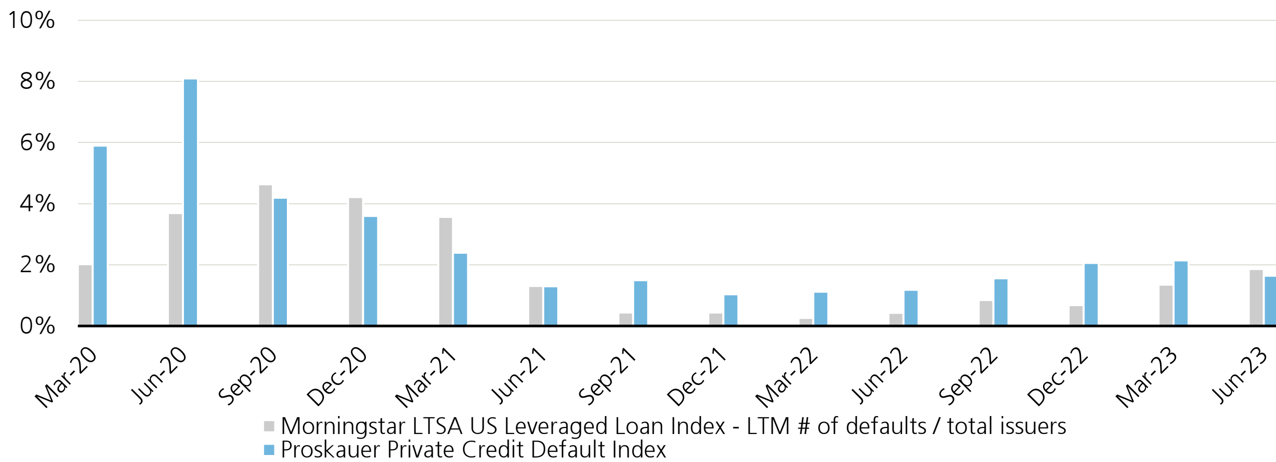
Source: Cliffwater Direct Lending Index, Morningstar Direct, Cambridge Associates, PitchBook, as of 31 Mar 2023.

What Are Debt Covenants?

Debt covenants are agreements between the lender and borrow. They are designed to protect the interest of the lender by ensuring the borrower remains financially stable enough to repay the debt. Common debt covenants include:

- Maintaining certain financial ratios – Requires the borrower to keep certain financial metrics such as leverage ratio (debt / EBITDA), interest coverage ratio (EBITDA / interest expense) below / above a threshold
- Restrictions on additional debt – Prevents the borrower from taking on additional debt that would make it harder to repay the existing loan
- Cash reserves / asset cushion – Requires certain amount of cash / collateral on hand

Fig 5: Private vs public default index



Source: Pitchbook LSTA, Proskauer, as of 30 Jun 2023.

Benefits and Risks
The benefits of direct lending include the floating rate structure which helps mitigate interest rate risk, as the coupon paid by the borrower resets periodically based on spread over a floating benchmark like the Secured Overnight Financing Rate (SOFR). This protects investors if interest rates rise (Fig 8). However, higher interest rates also puts increased pressure on a company's ability to pay back the loan or to refinance the debt.

Direct loans are typically secured by collateral which can provide downside protection in the case of default. These assets can include property, equipment, and intellectual property. Given that direct loans are negotiated directly with the company, managers of private debt have other levers they can use to extend the runway for payment, such as payment-in-kind (PIK), debt-for-equity swaps, equity injection from sponsors, or other negotiations with the company to avoid default. In addition, as these private direct loans are arranged with fewer lenders compared to syndicated loans, this can help contribute to quicker and more efficient workouts, and potentially greater recoveries.

Historically, direct loans have also seen higher defaults, during the COVID period for example (Fig 5). Investors should note that default rates are half of the credit risk story, it is also worth looking at the recovery rates. As most direct lending deals are first lien senior secured debt, we can look at historical public data to try to gauge the recovery rates (Fig 6.). Historically, the average recovery rate for first-lien loans is ~70%, which is where most direct lending is focused. While the average recovery rate for senior secured loans was 55%. Recent data from BAML shows recovery rates of leveraged loans YTD through May 2023 have trended between 66% and 70%. Since direct loans can also be sponsor-backed by private equity firms, this can provide another layer of due diligence, portfolio company oversight, and incentives to avoid default.

The biggest challenge to investing in direct loans is the illiquidity risk. Direct loans are typically structured with 5-7 year terms, tying up an investor's capital for that period. Direct lending is also not immune to economic downturns. If higher rates persist and we experience a prolonged recession, defaults could rise, cumulative losses could accrue, and investors might face a less liquid exit environment.

As direct loans are not publicly traded, they have lower volatility compared to more liquid loans. On the other hand, data transparency is often difficult to come by. The marked-to-market values of the investments is determined by the manager's valuation methodologies, similar to those in private equity. Managers often use third party valuation firms to conduct the valuations, which can provide an additional layer of reliability.

Fig 6: Recovery rates by instrument type (1987-2020)

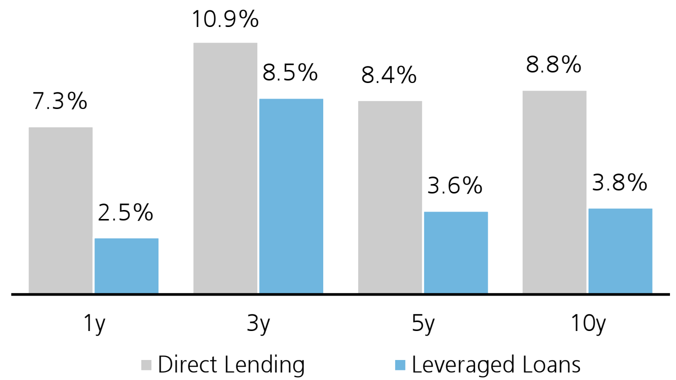
Instrument type	Dollar-weighted recovery rate
Term loans (first lien)	70.7
Term loans (second lien and unsecured)	53.5
Senior secured bonds	54.5
Senior unsecured bonds	42.2

Source: S&P, UBS.

Performance

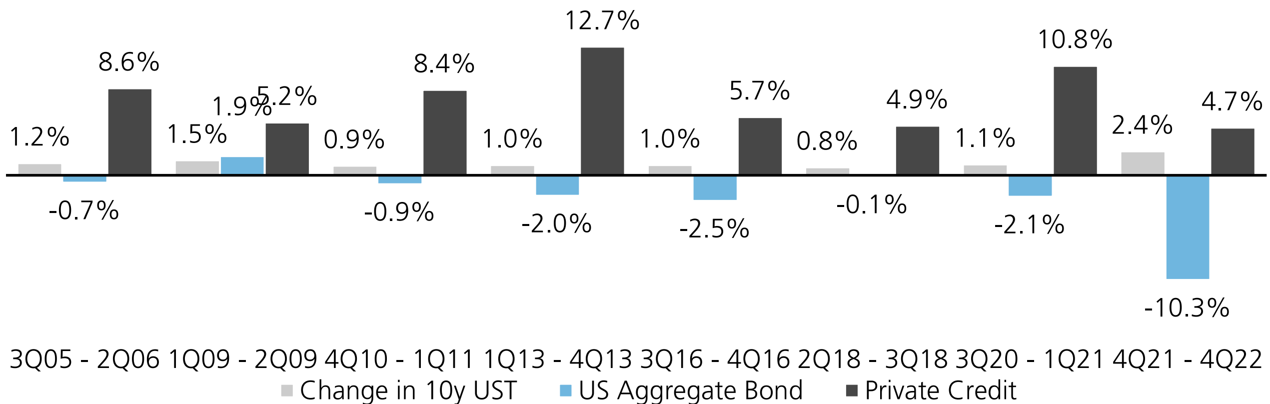
Direct loans, as measured by the Cliffwater Direct lending Index, have outperformed leveraged loans over the last 10 years by 5-6% (Fig 7). However, investors should note the low interest rate environment during that period. As mentioned earlier, borrowers are willing to pay a premium for certainty of execution, customization, and accessibility that private direct lending offers. Returns from direct lending come from several components. The main driver is the credit spread over the benchmark rate, such as SOFR. Spreads typically range from 500 to 600 basis points over SOFR. In comparison, leveraged loan spreads range from 400 to 550 basis points over the US-3year Treasuries. Direct loans also often have interest rate floors, so even if actual benchmark rates drop, there is a minimum yield, providing some spread protection in a declining rate environment. Target net internal rate of return (IRR) in direct loans are typically in the 6-10% range, though in today's high interest rate environment with SOFR around 5%, some managers are underwriting to a 12%-15% range.

Fig 7: Annualized total return of direct lending vs. leveraged loans



Source: Cliffwater Direct Lending Index, Morningstar Direct, UBS. As of 31 Mar 2023.

Fig 8: Private credit returns in rising rate environments



Source: Factset, Morningstar Direct, Cliffwater Direct Lending Index. As of 31 Mar 2023.

Key Takeaways

Private credit strategies like direct lending can offer an attractive option for investors looking to generate higher yields and diversify their portfolio from traditional fixed income. However, the illiquid nature introduces risks that must be properly assessed and managed to an individual's cash flow needs. Direct loans tend to provide more conservative risk-return profiles than leveraged loans and high yield bonds. Though defaults do occur, the secured structure of direct loans helps to protect principal. Direct lending strategies have insulated investors from rising rates due to their floating-rate nature while bonds have experienced equity like declines. For investors willing to lock up capital and commit for an extended period, direct lending offers access to an asset class with enhanced yield and downside mitigation.

Glossary of Terms

ABS – Asset backed securities. Consumer ABS are loans that are backed by interest paid from personal financial assets, such as student loans, credit card receivables, and auto loans.

BDC - Business development company. A closed-end investment company that was created by Congress in 1980 as a vehicle to drive growth capital to small businesses in the U.S. BDCs aggregate capital from individual investors and loan that capital largely to private U.S. middle market companies to help them operate and grow. Most BDC strategies are credit-focused and involve direct lending. They typically aim to generate attractive interest income from the loans originated to U.S. middle market companies. Some BDCs may choose to focus their investments on a specific industry, such as technology or healthcare, while others decide to diversify their holdings by investing in multiple market sectors.

A BDC can be structured in three different ways, depending on their capital raising strategy:

- Listed
- Non-listed
- Private

Listed BDCs' shares are registered with the SEC and are the most popular type of BDC. As a type of closed investment fund, the BDC raises capital within a discrete fundraising period and then proceeds to IPO, meaning its shares will be publicly traded on an exchange. It has a ticker and offers intraday trading and liquidity where investors can actively buy and sell shares. Since they are listed on an exchange, these BDCs are more volatile than non-listed and privately offered BDCs. Further, it has an infinite lifecycle and can operate indefinitely.

Non-listed BDCs, commonly known as non-traded BDCs, are not traded on an exchange and have a much less liquid structure compared to listed BDCs. A non-listed BDC generally offers a share repurchase program where a limited number of shares may be repurchased at NAV on a periodic basis. Repurchases can be subject to significant restrictions.

Private BDCs' shares are not registered with the SEC nor are their shares listed on an exchange. The shares of the BDC are sold through a private placement with minimal liquidity. They generally have a similar capital commitment and drawdown structure to private equity funds. In most instances, this type of BDC will have a planned liquidity event in 5-7 years following its fund closing, such as an IPO or winding down its structure via liquidation.

CLO – Collateralized loan obligation. A type of credit product that is backed by a pool of loans.

CRE – Commercial real estate. Commercial real estate loans are secured by commercial property.

Draw-down fund - A type of investment where capital is drawn down or called from investors as needed to make investments, rather than all the capital being collected upfront

Illiquid – The term used to describe an asset that cannot be quickly sold in the market without incurring a substantial loss.

IRR – Internal rate of return. The IRR is a measure of private investment performance. IRRs are determined by the amount and timing of cash inflows and outflows, as well as the residual value of investments at the end of the measurement period. The IRR is the discount rate that sets the net present value of a series of cash flows equal to zero. An IRR allows investors to measure the performance of a series of periodic uneven positive and negative cash flows and is especially relevant in the context of private equity investing, because capital is drawn down and invested over time.

Lock up – A period of time during which investors cannot redeem invested capital. For example, illiquid alternative investments such as venture capital, private equity and real estate funds typically have lockup periods before the full return of capital and profits to investors.

RMBS - Residential mortgage-backed securities. RMBS are loans backed by the interest paid on residential loans.

Secondary market – A market for the sale of existing private investments prior to their stated maturity. Traditionally, the secondary market has been focused on partnership interests in private equity funds. Certain secondary funds focus exclusively on purchasing secondary assets often at discounts to the last reported net asset value.

Non-Traditional Assets

Non-traditional asset classes are alternative investments that include hedge funds, private equity, real estate, and managed futures (collectively, alternative investments). Interests of alternative investment funds are sold only to qualified investors, and only by means of offering documents that include information about the risks, performance and expenses of alternative investment funds, and which clients are urged to read carefully before subscribing and retain. An investment in an alternative investment fund is speculative and involves significant risks. Specifically, these investments (1) are not mutual funds and are not subject to the same regulatory requirements as mutual funds; (2) may have performance that is volatile, and investors may lose all or a substantial amount of their investment; (3) may engage in leverage and other speculative investment practices that may increase the risk of investment loss; (4) are long-term, illiquid investments, there is generally no secondary market for the interests of a fund, and none is expected to develop; (5) interests of alternative investment funds typically will be illiquid and subject to restrictions on transfer; (6) may not be required to provide periodic pricing or valuation information to investors; (7) generally involve complex tax strategies and there may be delays in distributing tax information to investors; (8) are subject to high fees, including management fees and other fees and expenses, all of which will reduce profits.

Interests in alternative investment funds are not deposits or obligations of, or guaranteed or endorsed by, any bank or other insured depository institution, and are not federally insured by the Federal Deposit Insurance Corporation, the Federal Reserve Board, or any other governmental agency. Prospective investors should understand these risks and have the financial ability and willingness to accept them for an extended period of time before making an investment in an alternative investment fund and should consider an alternative investment fund as a supplement to an overall investment program.

In addition to the risks that apply to alternative investments generally, the following are additional risks related to an investment in these strategies:

- Hedge Fund Risk: There are risks specifically associated with investing in hedge funds, which may include risks associated with investing in short sales, options, small-cap stocks, “junk bonds,” derivatives, distressed securities, non-U.S. securities and illiquid investments.
- Managed Futures: There are risks specifically associated with investing in managed futures programs. For example, not all managers focus on all strategies at all times, and managed futures strategies may have material directional elements.
- Real Estate: There are risks specifically associated with investing in real estate products and real estate investment trusts. They involve risks associated with debt, adverse changes in general economic or local market conditions, changes in governmental, tax, real estate and zoning laws or regulations, risks associated with capital calls and, for some real estate products, the risks associated with the ability to qualify for favorable treatment under the federal tax laws.
- Private Equity: There are risks specifically associated with investing in private equity. Capital calls can be made on short notice, and the failure to meet capital calls can result in significant adverse consequences including, but not limited to, a total loss of investment.
- Foreign Exchange/Currency Risk: Investors in securities of issuers located outside of the United States should be aware that even for securities denominated in U.S. dollars, changes in the exchange rate between the U.S. dollar and the issuer’s “home” currency can have unexpected effects on the market value and liquidity of those securities. Those securities may also be affected by other risks (such as political, economic or regulatory changes) that may not be readily known to a U.S. investor.

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