Private Credit 101

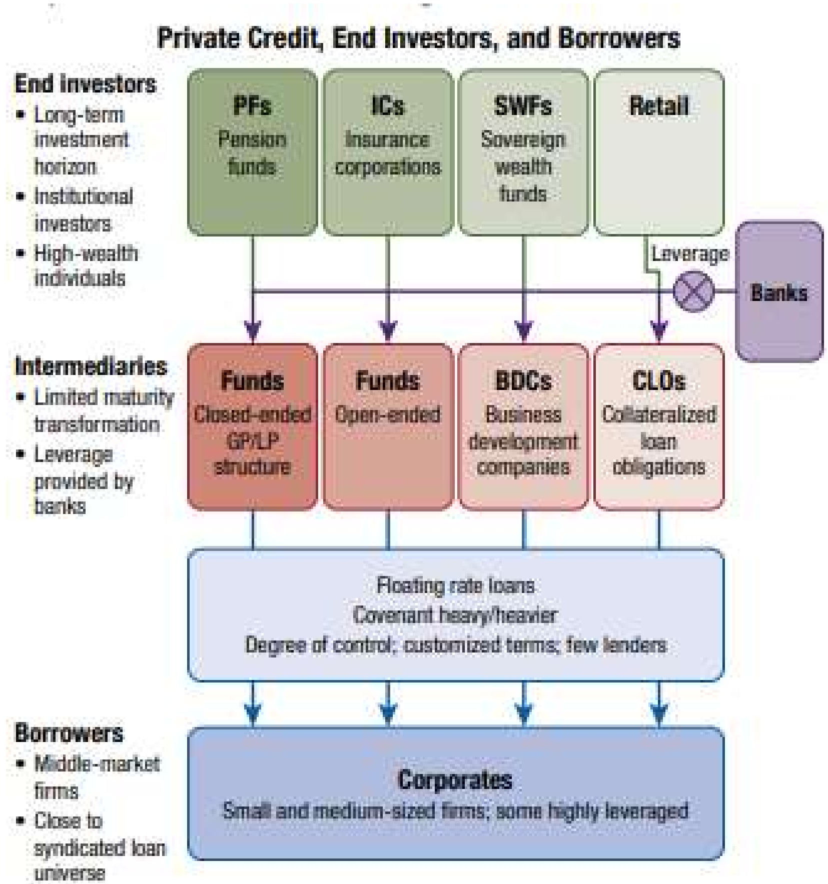
Zachary Griffiths, CFA
Head of IG and Macro Strategy
zgriffiths@creditsights.com

April 2024

What is Private Credit?

Private credit refers to disintermediated lending conducted directly between a non-depository financial institution (i.e. non-bank) lender, such as asset managers, and a corporate borrower, often private equity-owned companies.

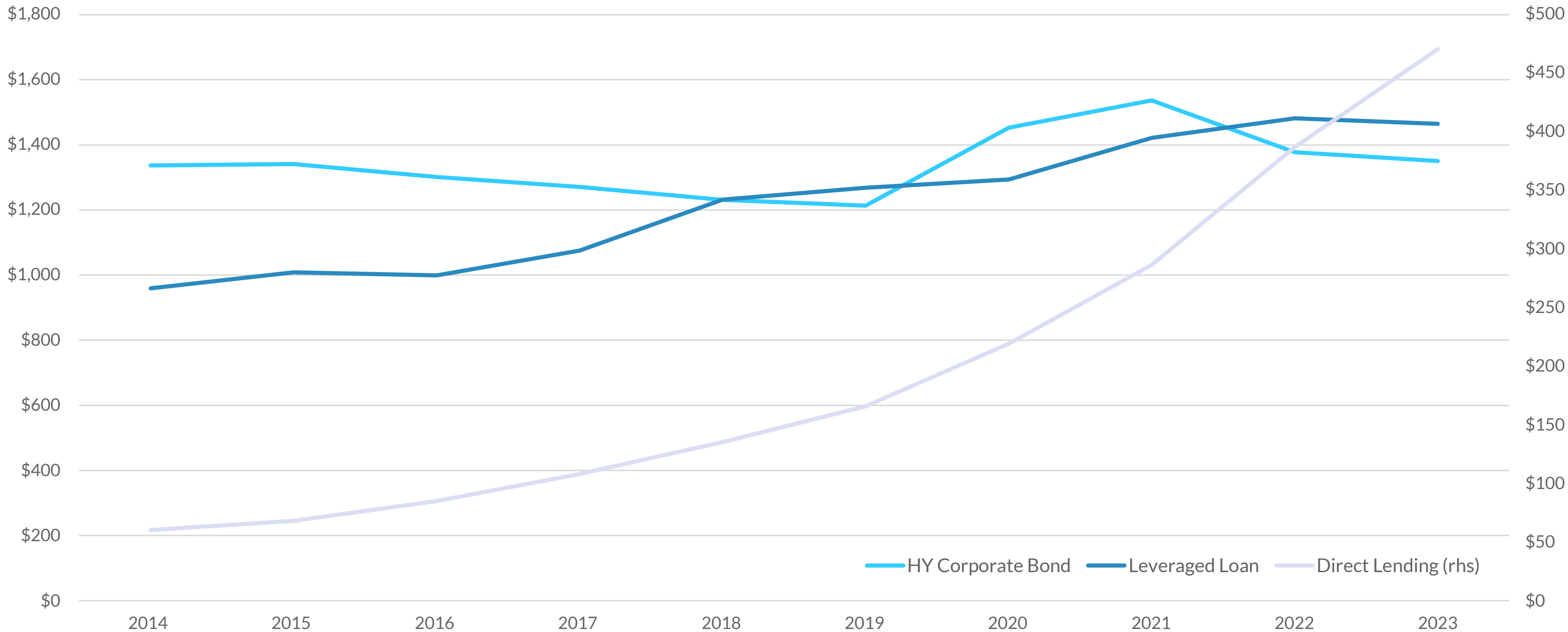
- **Direct Lending - relatively straightforward loan agreement between a non-bank lender and a private borrower**
- Mezzanine - hybrid form of capital that sits between senior debt and equity in company's capital structure
- Special Situations - lending to companies in non-traditional, complex or distressed scenarios that require tailored financing solutions
- Private Collateralized Loan Obligations (CLOs) – structured SPV using private credit loans as underlying collateral pool



 Source: CreditSights, IMF Global Financial Stability Report, April 2024, "The Last Mile: Financial Vulnerabilities and Risks."

The Rise of Private Credit: Direct Lending in Context

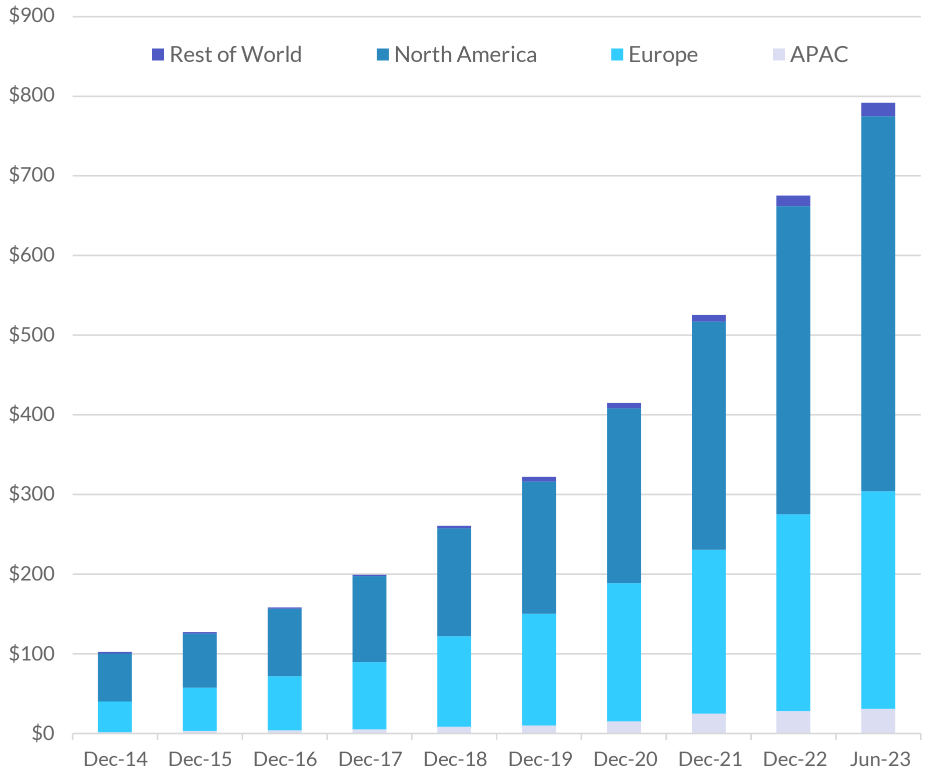
Growth in US Direct Lending AUM: Nearly a 3x increase since 2019 (+35% annualized) to $471 billon
Growth in LL and HY Bond Market: 1.2x increase since 2019 (3-4% annualized) to ~$1.4 trillion



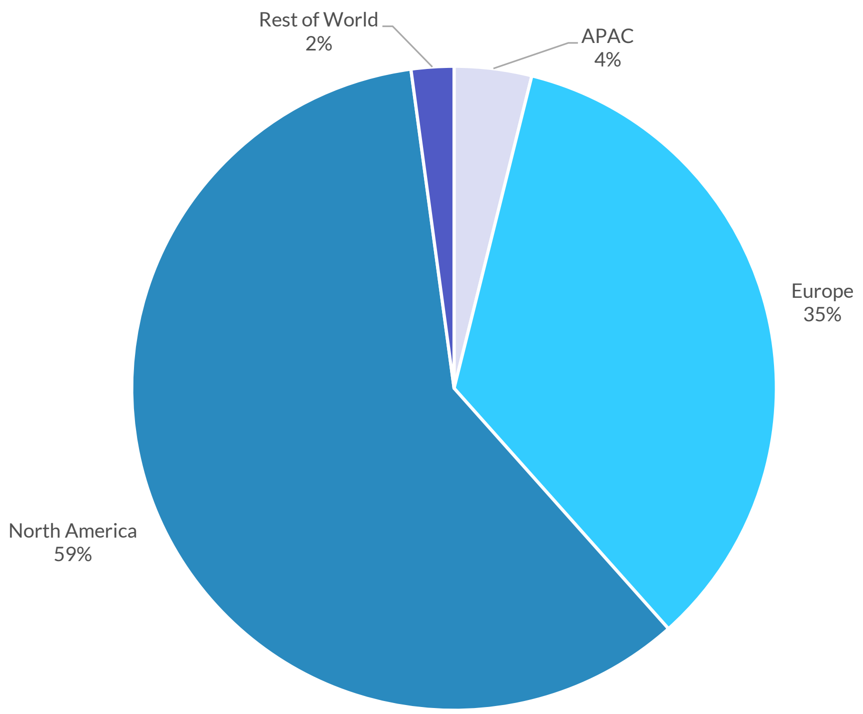
Source: CreditSights, Preqin, FactSet, ICE Data Indices, LLC, Credit Suisse Leveraged Loan Index
Note: Data as of June 30, 2023. HY Corporate Bond (H0A0, Leveraged Loans (CSLL)

Global Direct Lending Totaled Roughly $800 Billion in June 2023

North American direct lending has grown to $471 billion in 2023, from $60 billion a decade ago



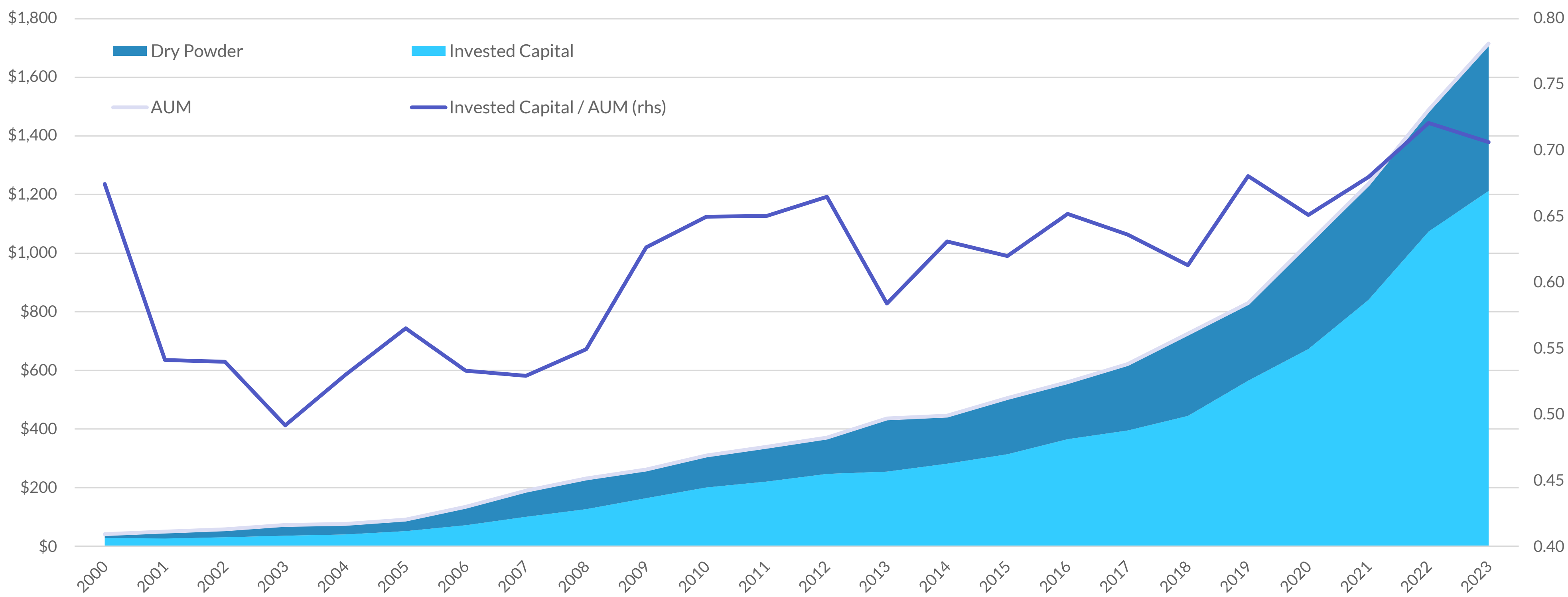
North America and Europe comprise most of the global direct lending market at 59% and 35%, respectively



Source: CreditSights, Federal Reserve Board, Preqin

Global Private Credit AUM Hit $1.7 Trillion in 2023

Roughly 70% of the capital raised has been deployed, leaving $500 billion in dry powder

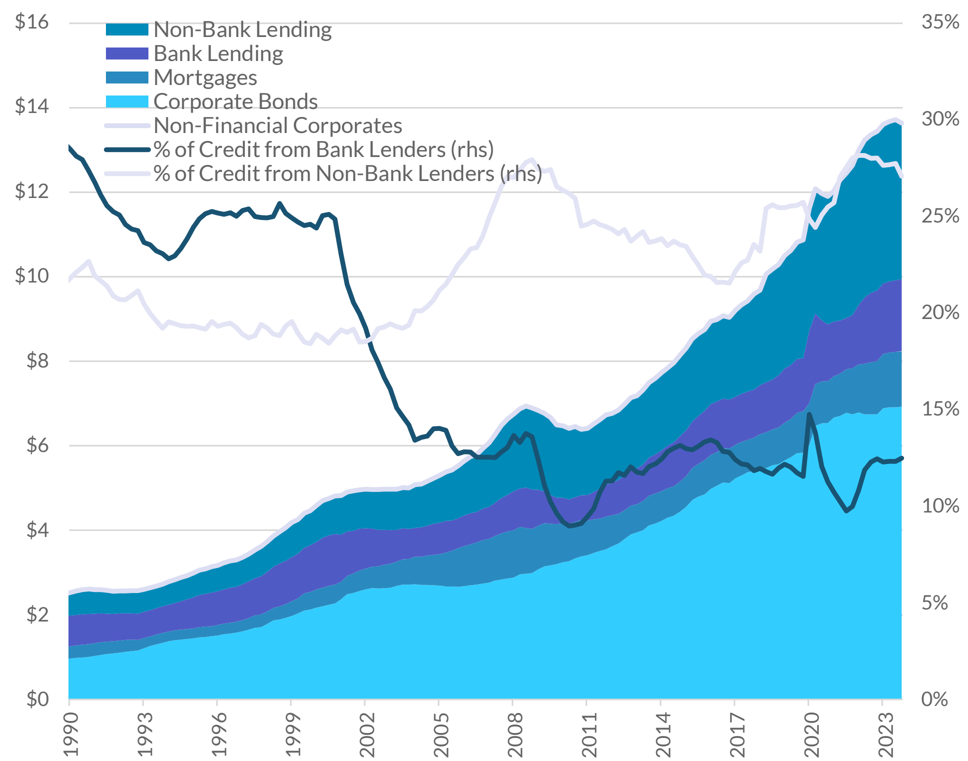


Source: CreditSights, Federal Reserve Board, Preqin
Note: Data as of June 2023. Figures include all strategies (i.e. direct lending, mezzanine and special situations) and asset classes (including securitizations)

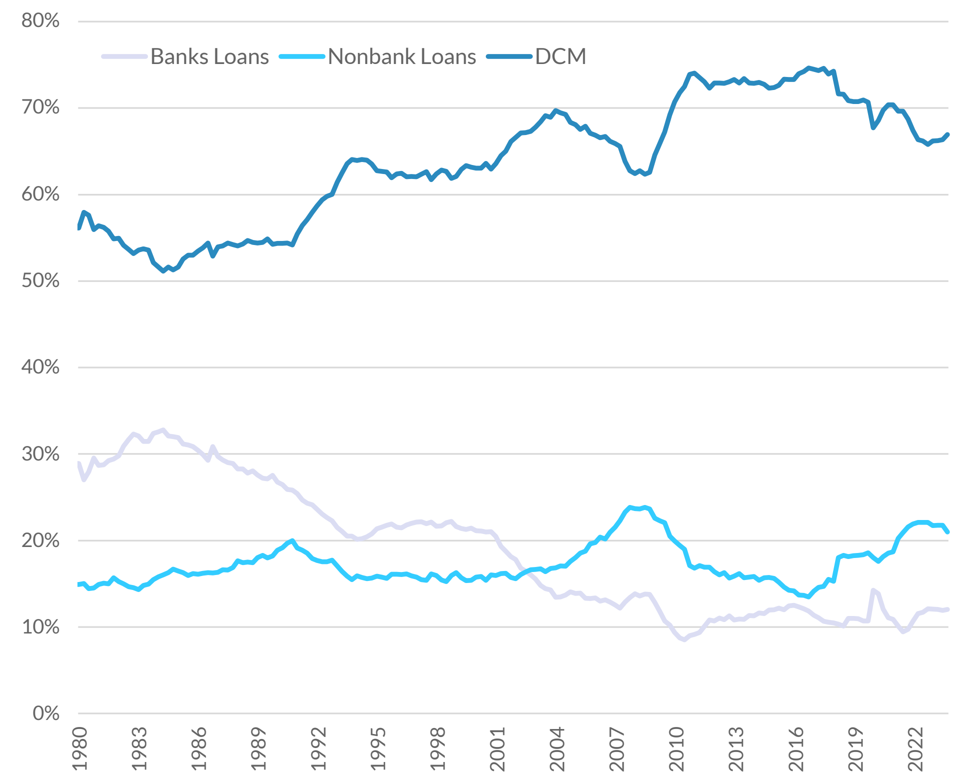
What Has Driven the Rise of Private Credit?

Growing Corporate Borrowing Needs Amid Fading Bank Funding Supply

Non-financial corporate borrowing more than doubled to $12.3 trillion in Q4 2023 from $5.5 trillion in Q4 2007



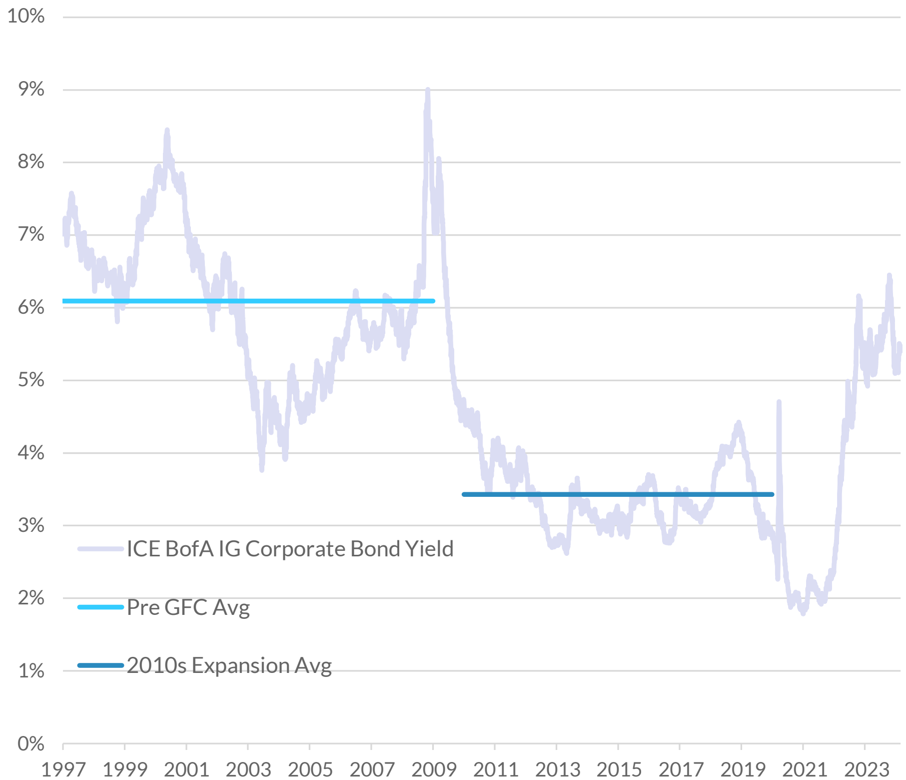
Non-financial corporates source just 12% of their financing from banks now vs nearly 30% in the early '90s



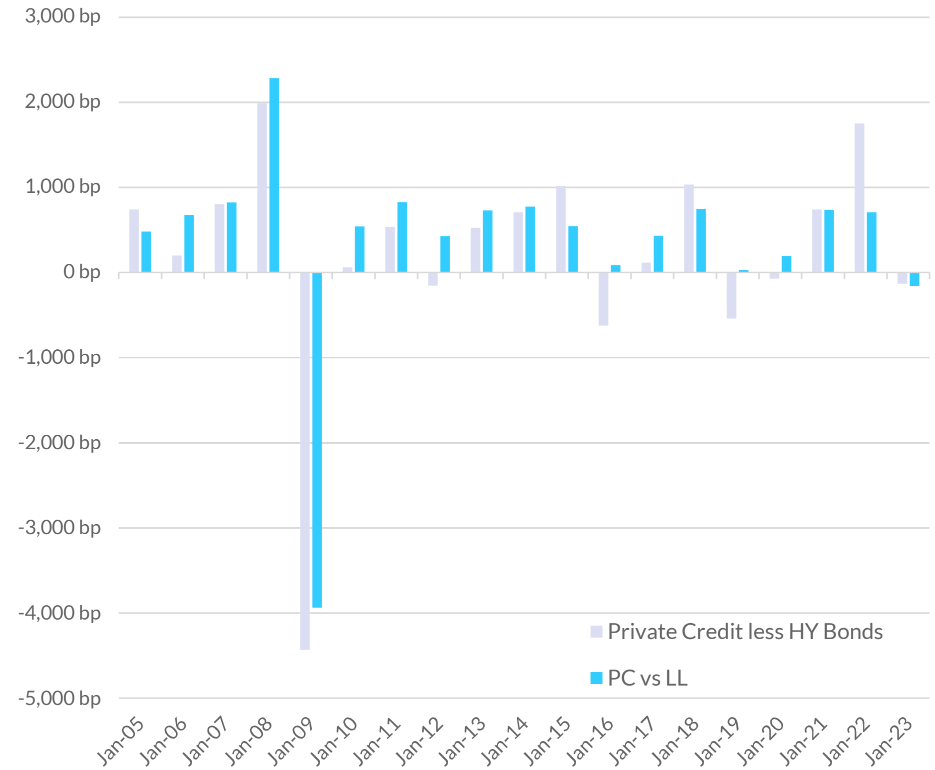
Source: CreditSights, Federal Reserve

Reach For Yield Amid Low Interest Rate Environment

The pre-crisis yield on IG corporate bonds was just north of 6%, versus around 3.5% post-crisis/pre-covid



Private Credit outperformed HY bonds and lev. loans by 224 bp, and 366 bp over the long-term, respectively



Source: CreditSights, Cliffwater, ICE Data Indices, LLC

Six Key Benefits to Borrowers

1. Greater closing certainty	particularly in volatile market conditions or economic downturns when deals in the broadly syndicated market may fail to close, resulting in a hung syndication;
2. Faster deal execution	with deals pricing within weeks compared to two or more months in the syndicated debt market;
3. Pricing certainty	compared to broadly syndicated loans, which can fluctuate in price before close depending on technical factors such as lender demand and market conditions;
4. Greater confidentiality	a draw for issuers wishing to avoid disclosing proprietary information to a broad investor base that may reach competitors;
5. Willingness to provide greater leverage	than the broadly syndicated loan market; and
6. Customization	of deal terms and covenants.

Source: CreditSights

Structuring

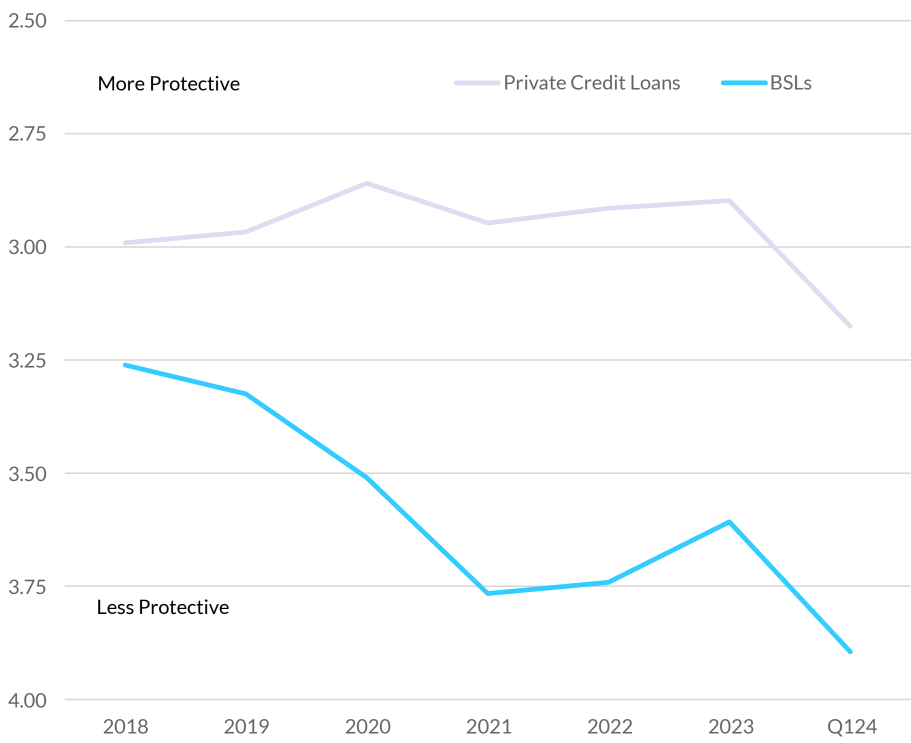
Private Credit vs Broadly Syndicated Loan Structures

	Private Credit	BSL
Coupon Type	Floating rate; spread over reference rate, typically SOFR	Floating rate; spread over reference rate, typically SOFR
Capital Structure	Commonly senior, first lien, secured loans, though unitranche loans (a mix of senior and second lien loans) are growing in popularity	Senior secured loans, however can vary to include first- and second-lien or senior and junior debt
Lender	Single non-bank lender to small group of non-bank lenders; typically 1-6 lender participants, though can range to over 20	Arranged by a large commercial or investment bank and syndicated across a group of lenders; ranging from dozens up to 200 participants
Rating	Borrowers typically unrated or privately rated	Borrowers usually have public credit rating
Pricing	More expensive than BSL due to illiquidity premium	Cheaper pricing as loans can be easily traded on secondary market. Oftentimes driven by technical rather than fundamental factors due to broader investor base
Liquidity	Illiquid, typically held to maturity	Liquid
Secondary Market	Nascent secondary market for LP-led transactions for interests in fund(s) or GP-led transactions for fund assets	Well-developed secondary trading market
Maturity	Maturity between five to seven years, though oftentimes repayed earlier at around three years	Maturity between five to seven years, also frequently repaid earlier
Covenants	More protective, customized covenants covering both maintenance and incurrence financial covenants	Often cov-lite, which only have incurrence covenants
Deal Execution	Faster execution, can be as quick as 30-75 days. Guarantee of deal execution, size and pricing as negotiated	Longer execution, typically two months. Committed or best-efforts basis financing. In a committed transaction, the borrower is guaranteed to obtain the agreed upon amount whereas in a best-efforts transaction, the loan size and interest depends on market appetite and is not guaranteed
Deal Size	Deal size typically <$500 million (with some larger deals more recently)	Deal size typically ranges between $500 million-$1 billion (but can be larger)

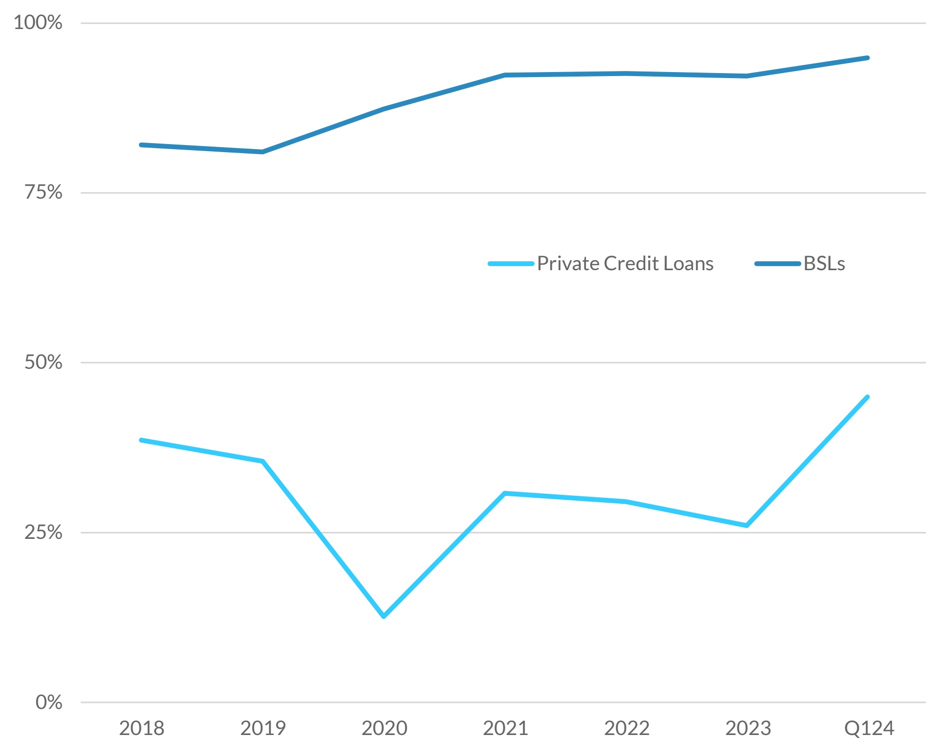
Source: CreditSights, Fitch Ratings, Covenant Review

Private Loan Documentation is More Protective for PC than for BSLs

Average Documentation Score of New-Issue Private Credit Vs. Broadly Syndicated First Lien Loans



Covenant-Lite Share of New-Issue Private Credit vs. Broadly Syndicated First Lien Loans

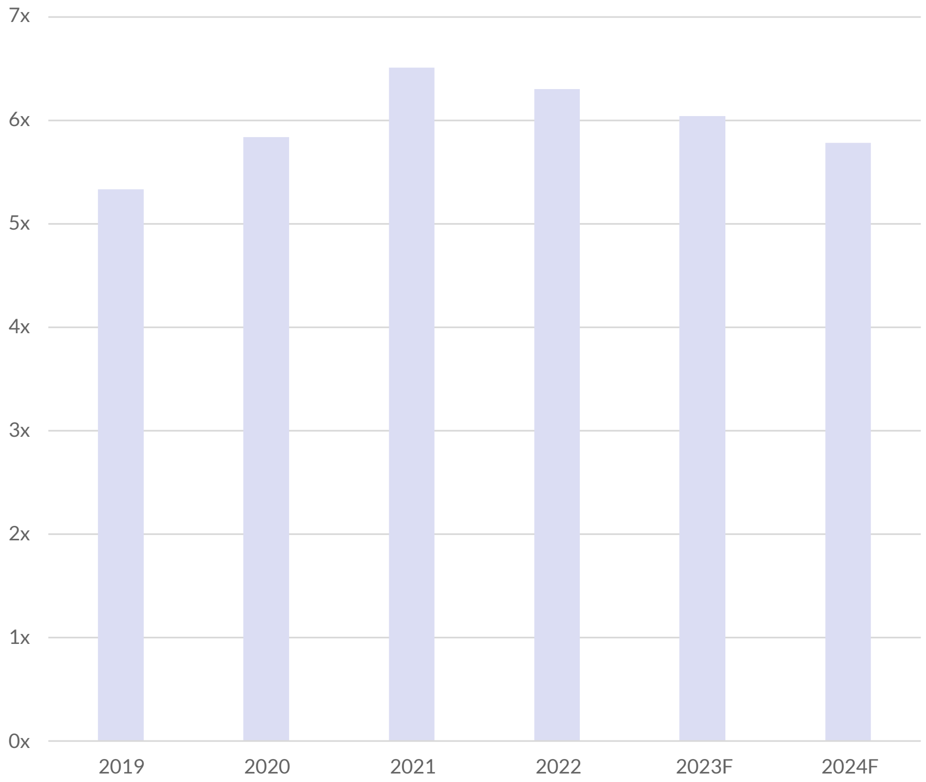


Source: Covenant Review, A Fitch Solutions Company

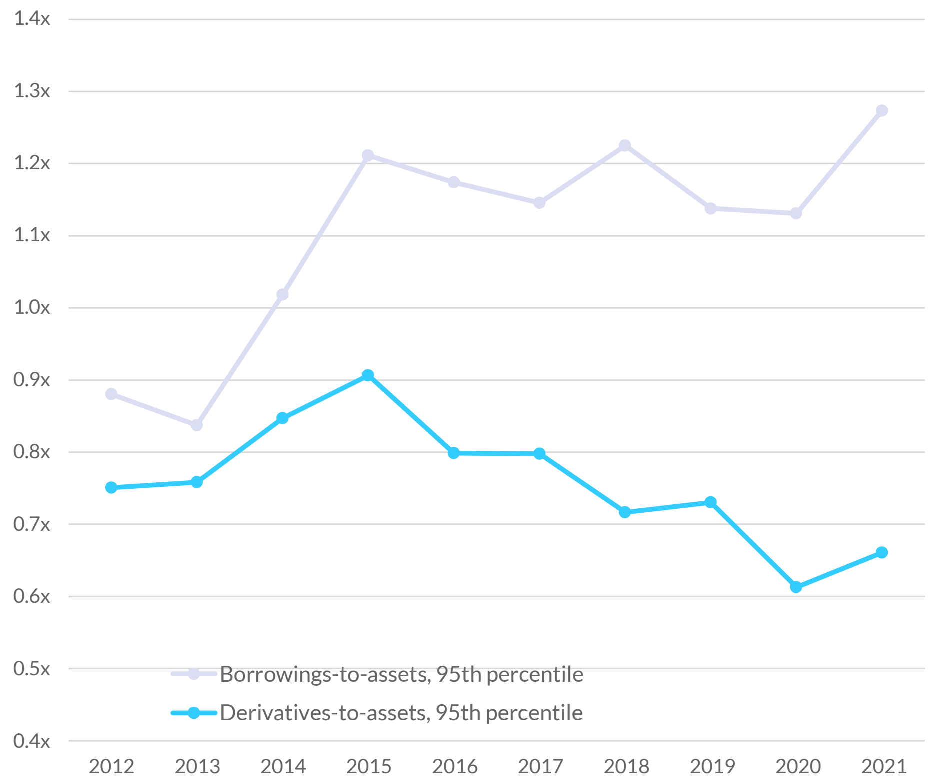
Risks to Consider

Portfolio Company or Private Credit Fund Leverage Could Rise Materially

Median leverage for Fitch's PMR portfolio has fallen from a peak of 6.5x in 2021 and is expected to fall further

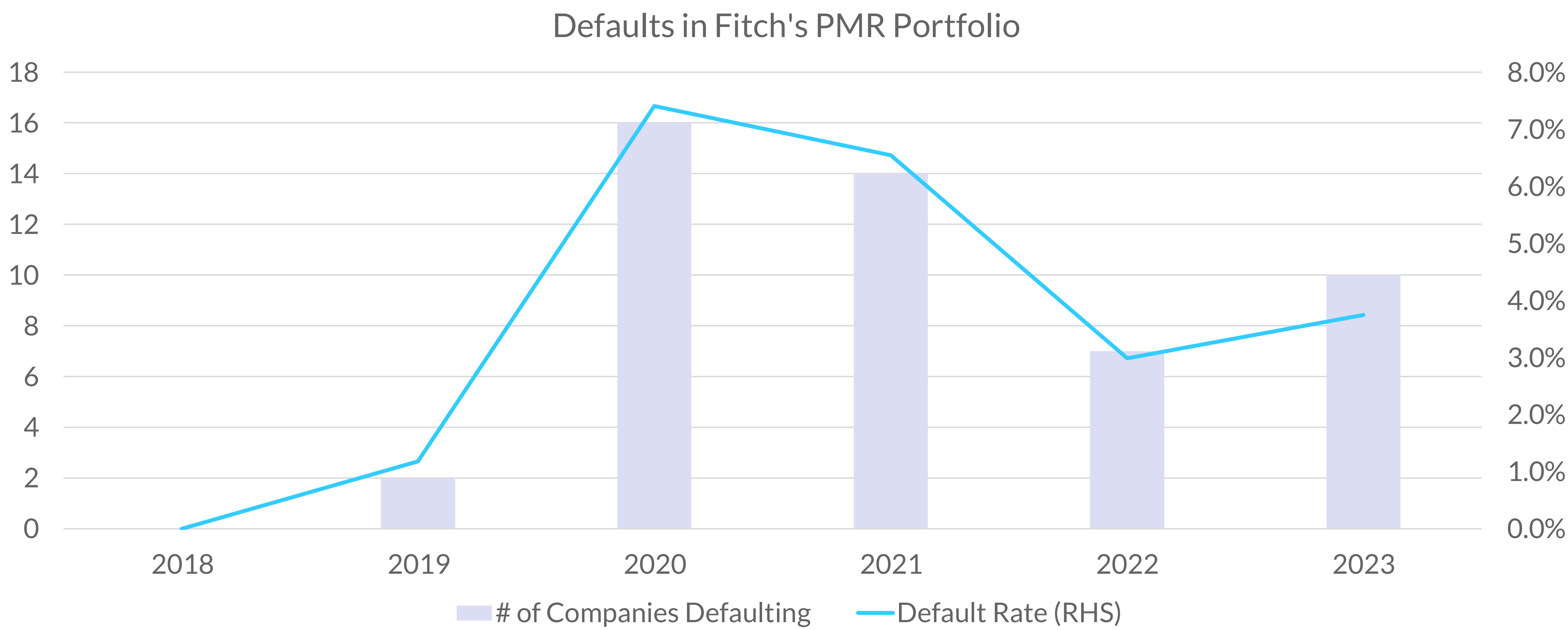


Fund leverage remains manageable at a little less than 1.3x as of the end of 2021



Source: CreditSights, Fitch Ratings, Fitch Solutions, Federal Reserve Board, Securities and Exchange Commission, Form PF, Reporting Form of Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors

Defaults Rise in More Adverse Economic Scenario



Source: CreditSights, Fitch Ratings, Fitch Solutions

Default Outcomes are Bifurcated

Total: 37

Sold: 9

Bankruptcy: 6

1LTL Recovery
- >= 75%: 2
- <=25%: 3[a]
- N.A.: 1

Strategic: 6

1LTL Recovery
- >=75%: 6
- <=25%: 0

Rating at sale
- B: 1
- CCC: 5

Financial: 3

1LTL Recovery
- >=75%: 3
- <=25%: 0

Rating at sale
- B: 2
- CCC: 1

Refi'd: 2

Rating at refinancing
- B: 0
- CCC: 2

Still Rated: 20

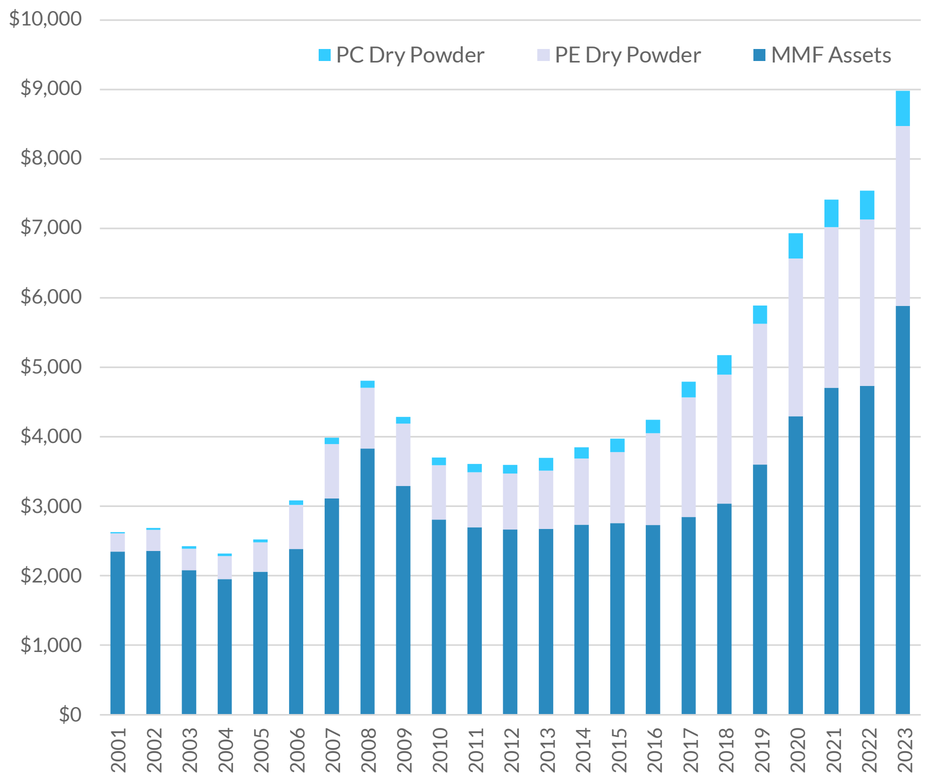
Current rating
- B: 2
- CCC/Below: 18

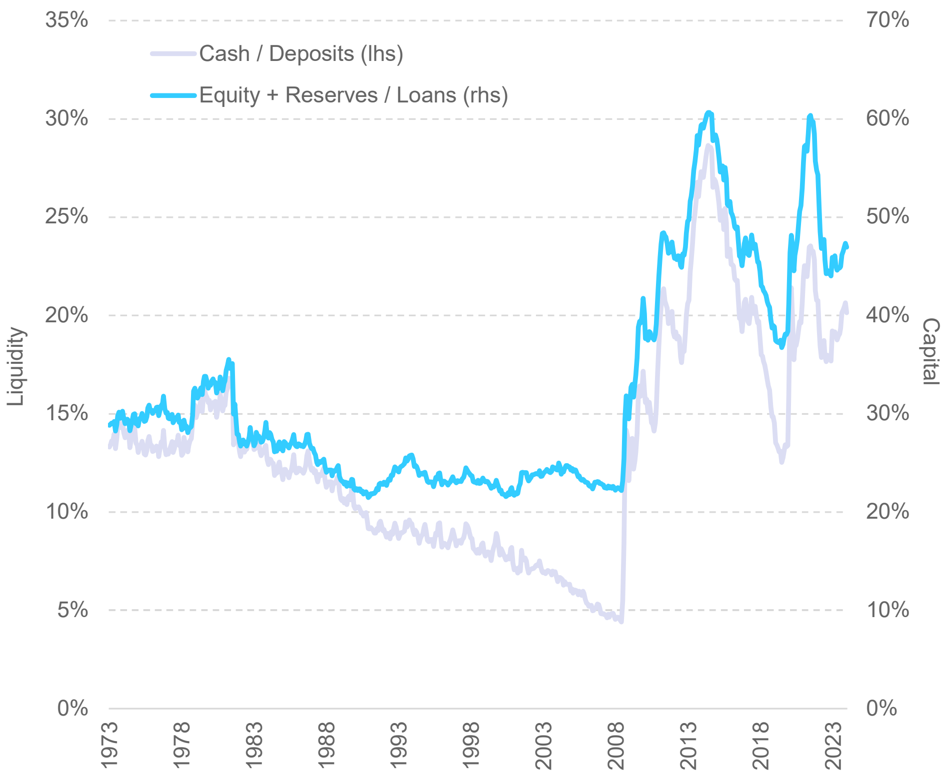
[a]Includes one term loan, which went through a distressed debt exchange pre-bankruptcy that swapped most first lien term loan debt for equity, while the remaining first lien term loans recovered 100%, the equity was wiped out in Chapter 11 such that the recovery from the initial investment was under 10%. 1LTL – First lien term loan. N.A. – Not applicable.

Source: CreditSights, Fitch Ratings, Fitch Solutions

Severe Market Drawdown Could Cause Liquidity Squeeze…

…but the system is awash with cash. The combination of PC/PE dry powder and money fund assets has more than tripled since the early 2000s, doubling the pace of inflation. Banks are also well-capitalized.





Source: CreditSights, Preqin, Federal Reserve Board, FDIC

CreditSights
a FitchSolutions Company

Research
CovenantReview
LevFinInsights