

Private Credit 101

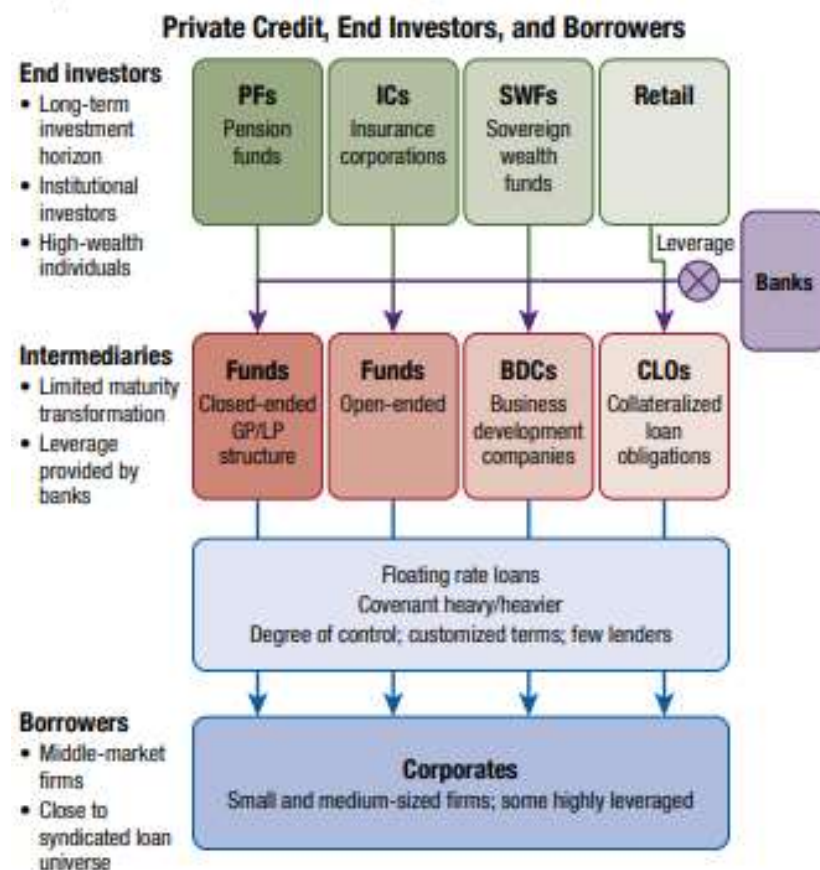
Zachary Griffiths, CFA
Head of IG and Macro Strategy
zgriffiths@creditsights.com

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.

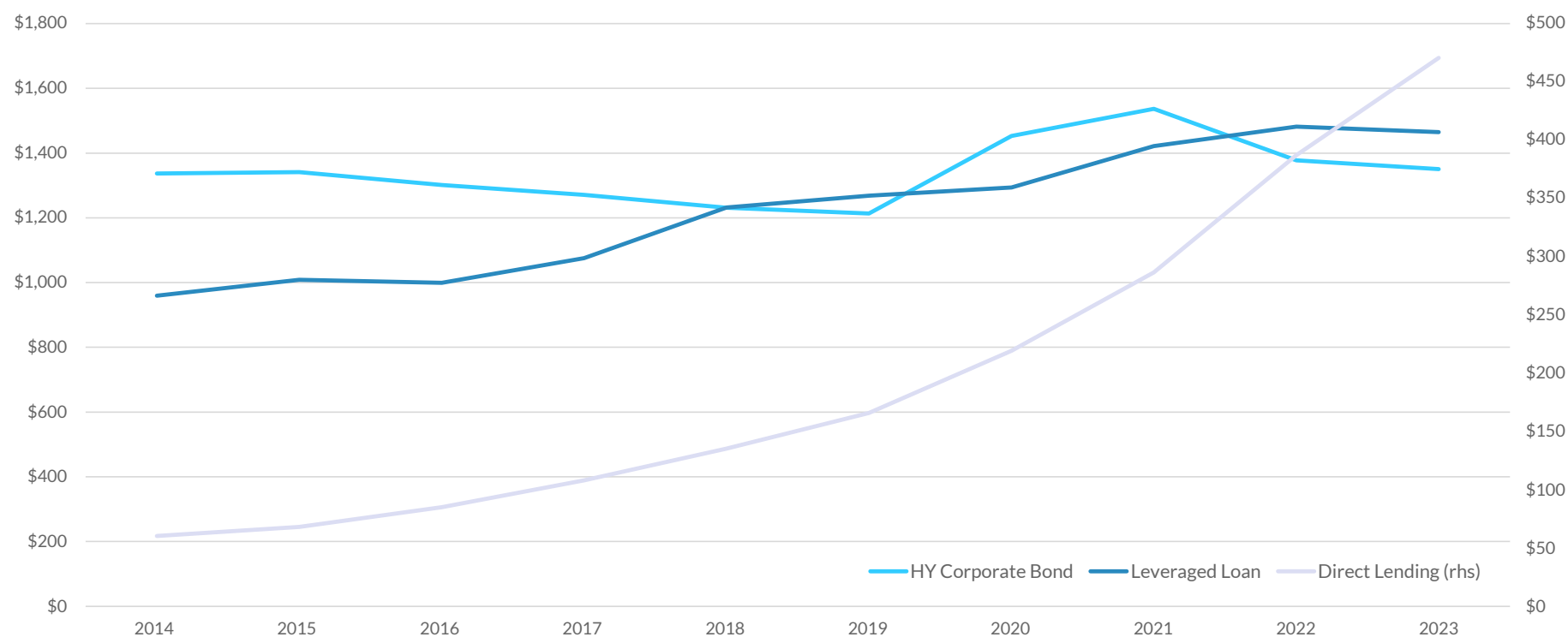
- **Direct Lending** - relatively straightforward loan agreement between a non-bank lender and a private borrower
- **Mezzanine** - hybrid form of capital that sits between senior debt and equity in company's capital structure
- **Special Situations** - lending to companies in non-traditional, complex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



The Rise of Private Credit: Direct Lending in Context

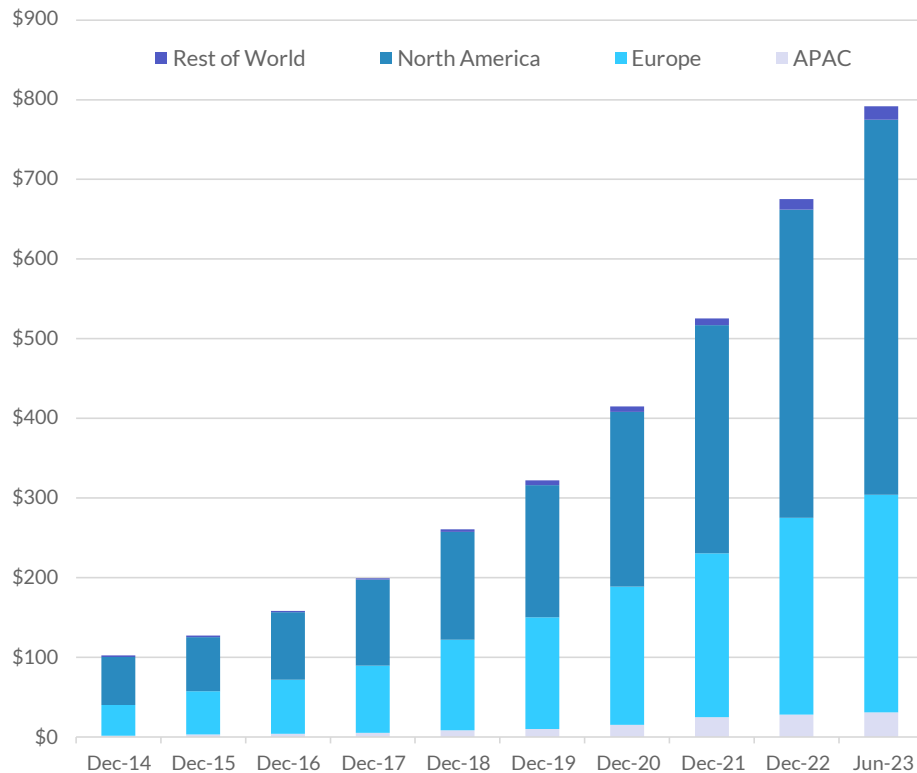
Growth in US Direct Lending AUM: Nearly a 3x increase since 2019 (+35% annualized) to \$471 billion

Growth in LL and HY Bond Market: 1.2x increase since 2019 (3-4% annualized) to ~\$1.4 trillion

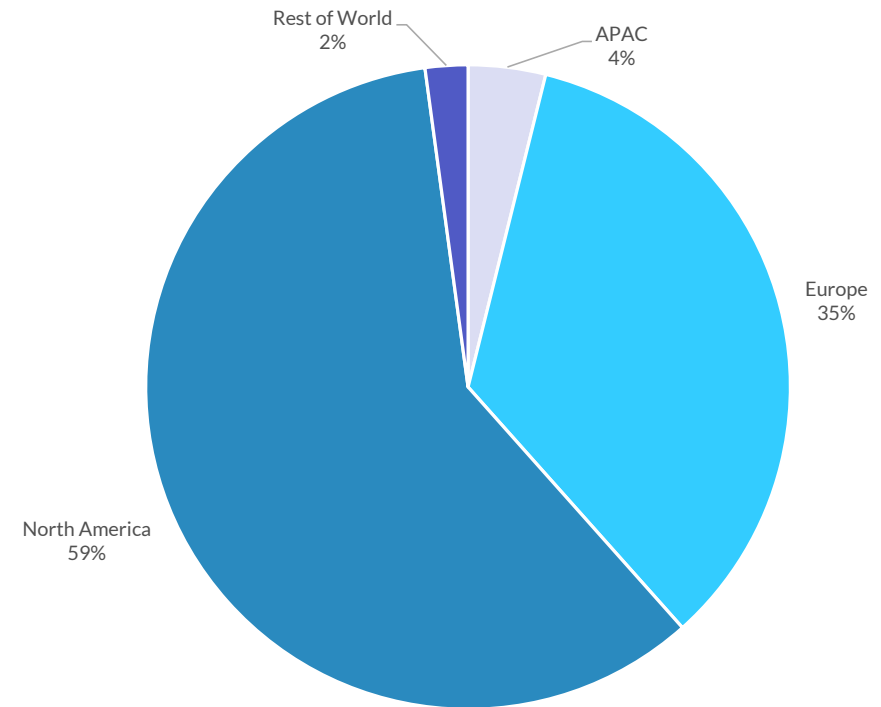


Global Direct Lending Totaled Roughly \$800 Billion in June 2023

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

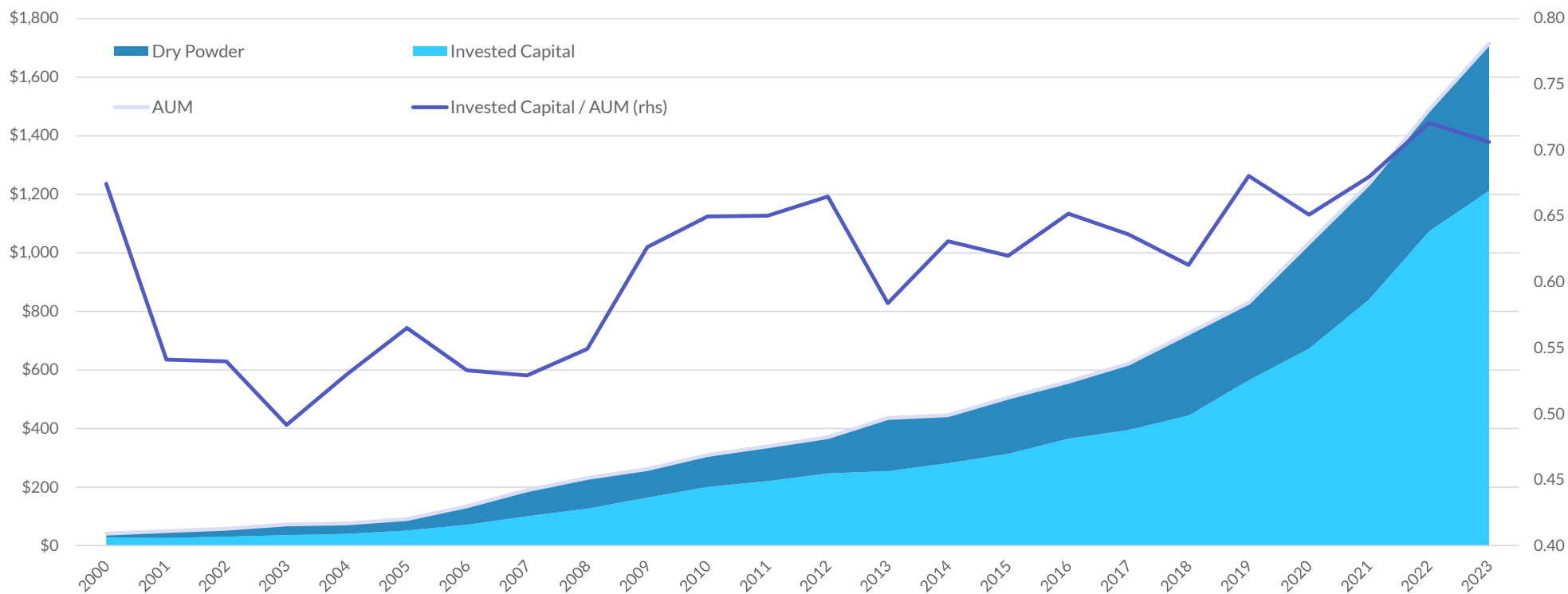


North America and Europe comprise most of the global direct lending market at 59% and 35%, respectively



Global Private Credit AUM Hit \$1.7 Trillion in 2023

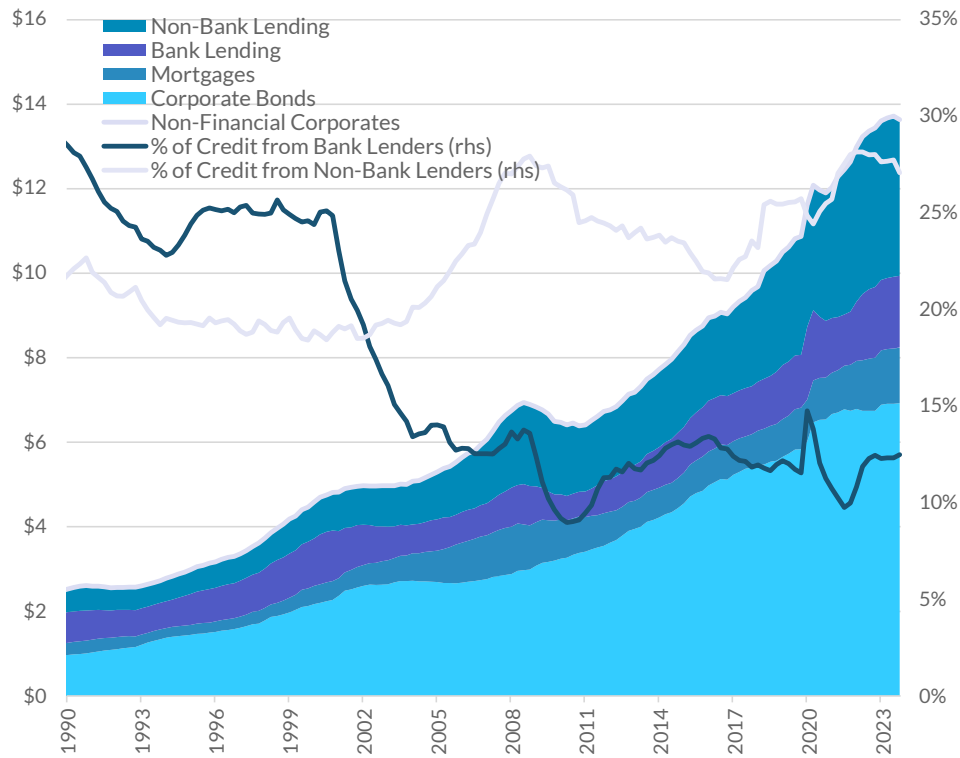
Roughly 70% of the capital raised has been deployed, leaving \$500 billion in dry powder



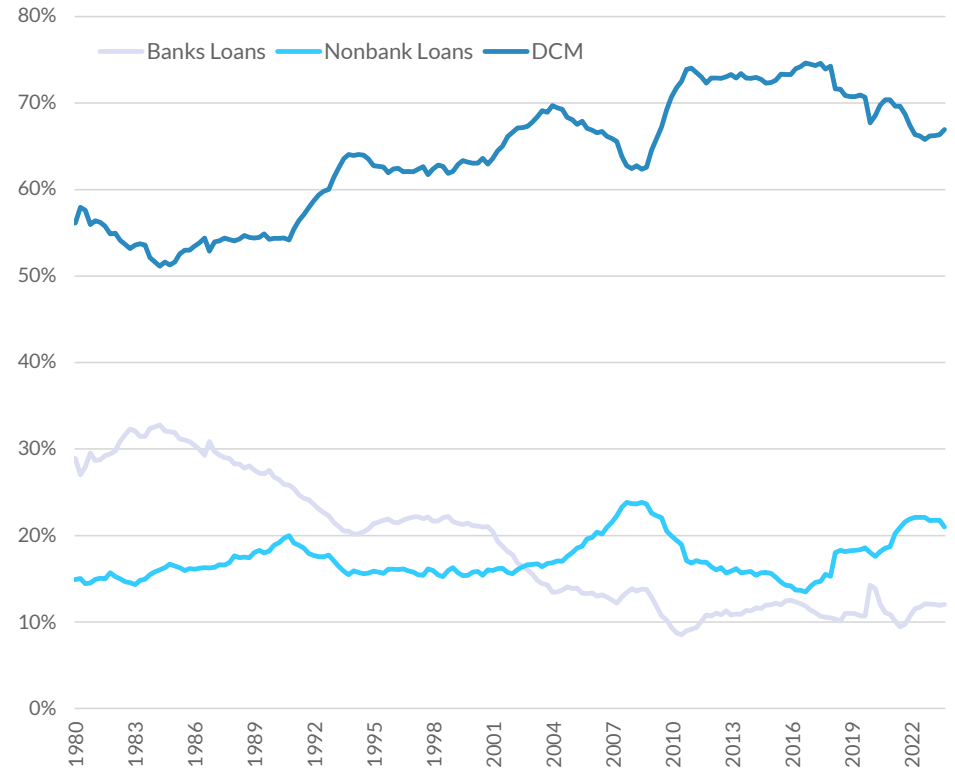
What Has Driven the Rise of Private Credit?

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

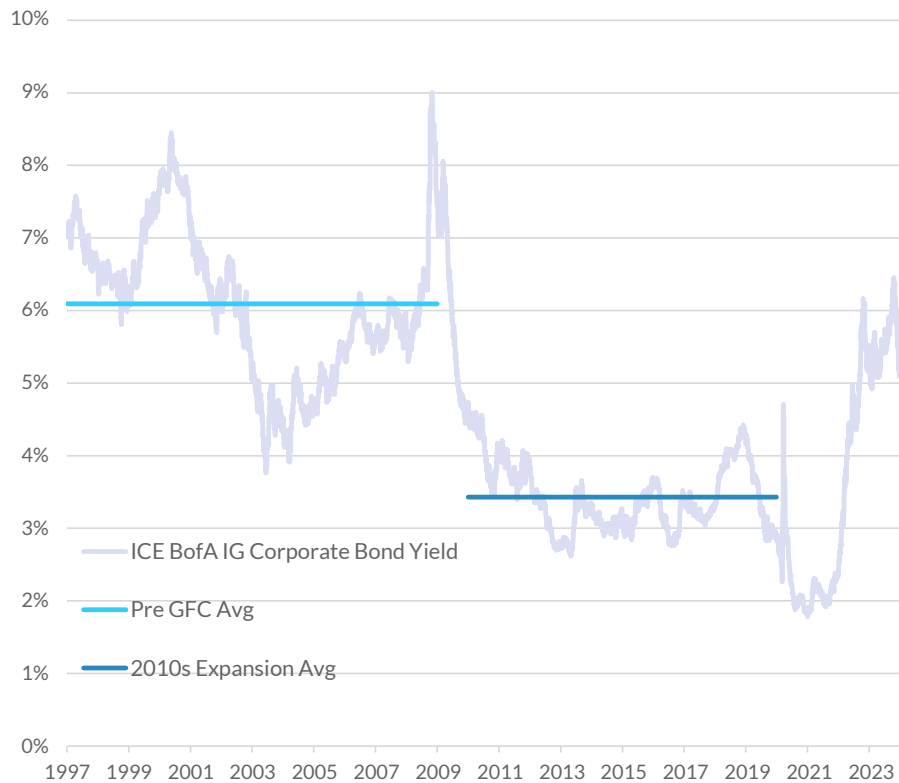


Non-financial corporates source just 12% of their financing from banks now vs nearly 30% in the early '90s

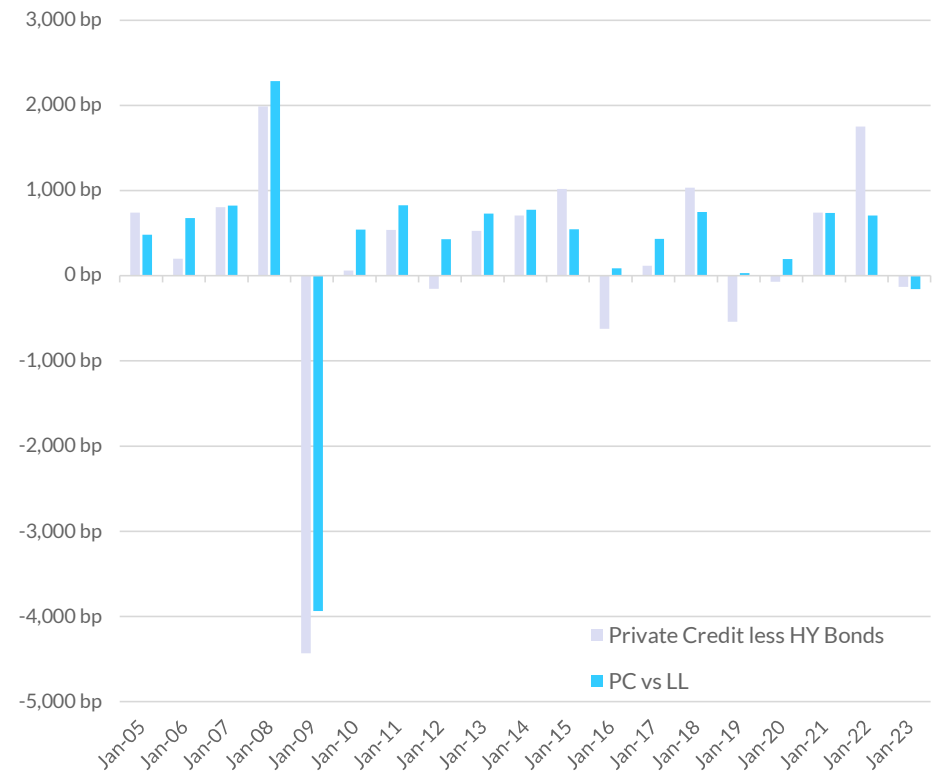


Reach For Yield Amid Low Interest Rate Environment

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



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.

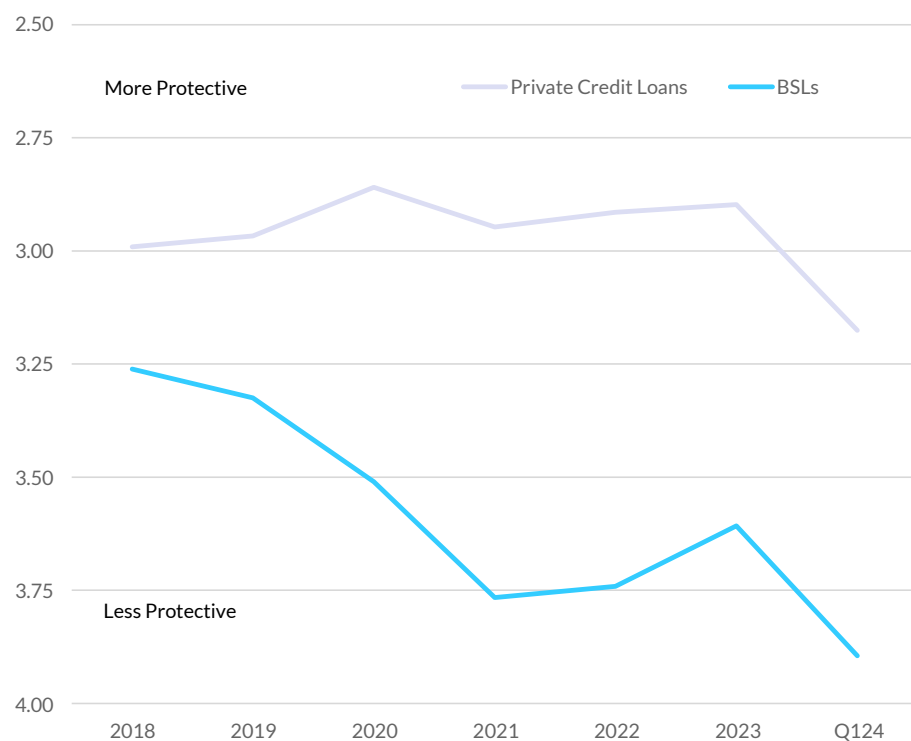
Structuring

Private Credit vs Broadly Syndicated Loan Structures

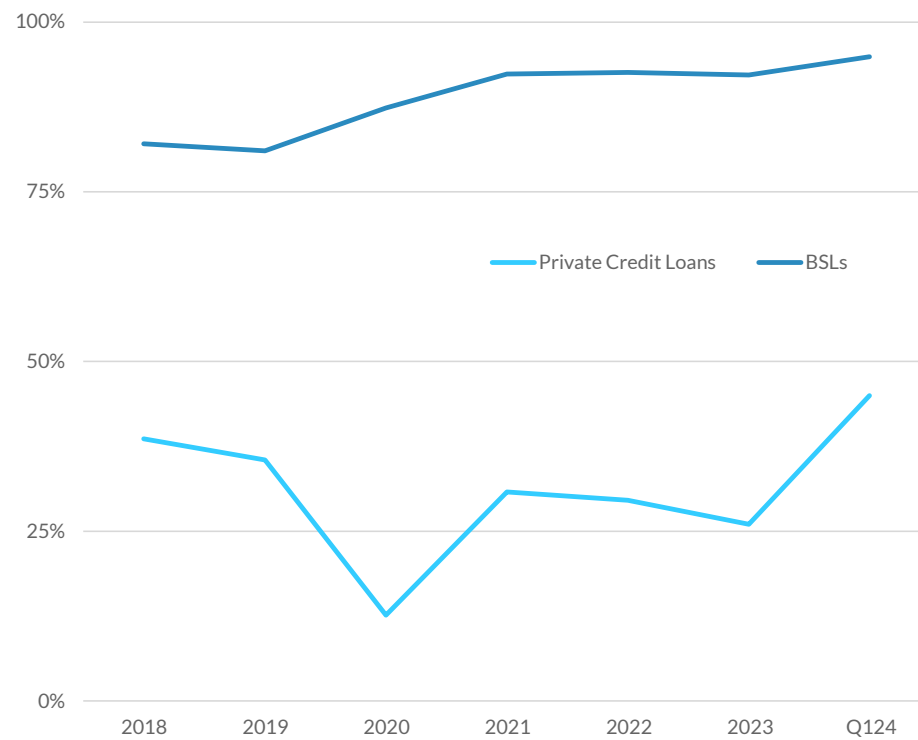
	Private Credit	BSL
Coupon Type	Floating rate; spread over reference rate, typically SOFR	Floating rate; spread over reference rate, typically SOFR
Capital Structure	Commonly senior, first lien, secured loans, though unitranche loans (a mix of senior and second lien loans) are growing in popularity	Senior 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)

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



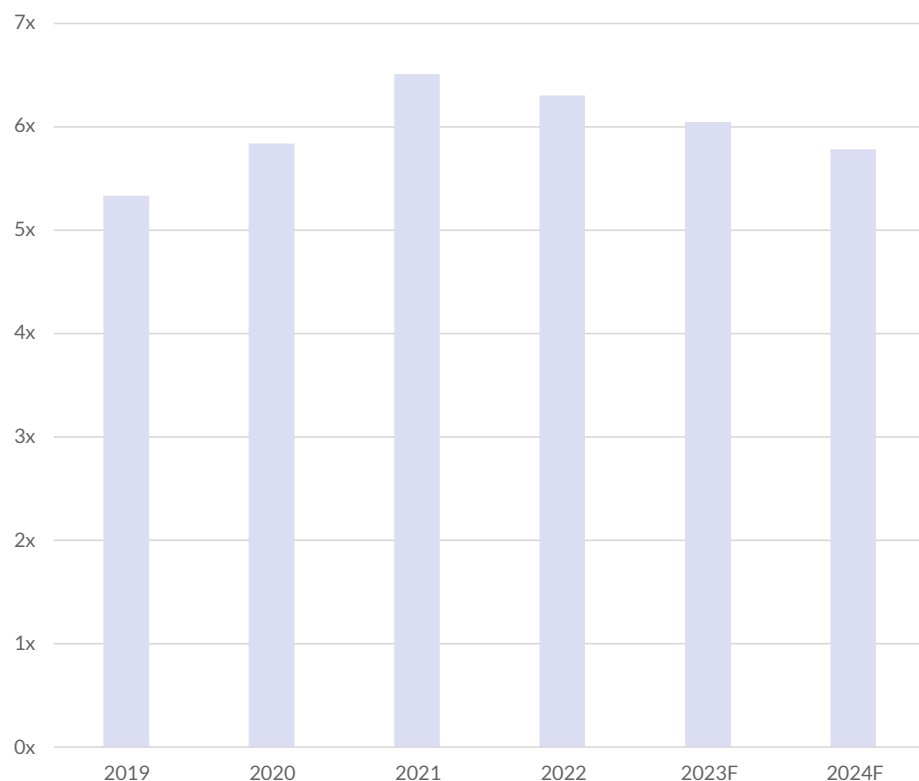
Covenant-Lite Share of New-Issue Private Credit vs. Broadly Syndicated First Lien Loans



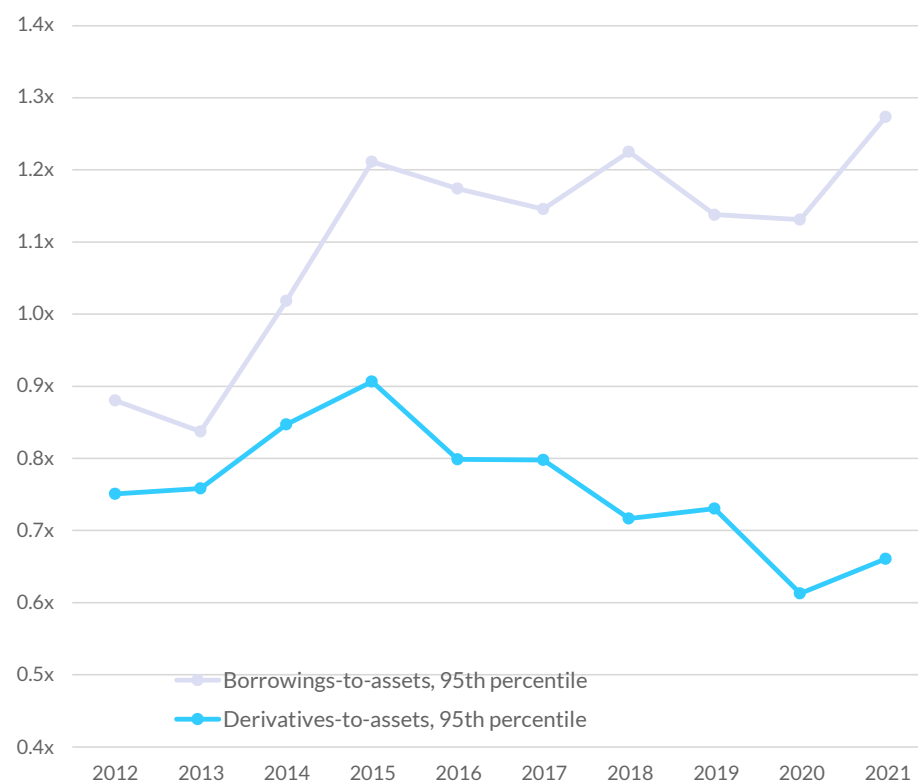
Risks to Consider

Portfolio Company or Private Credit Fund Leverage Could Rise Materially

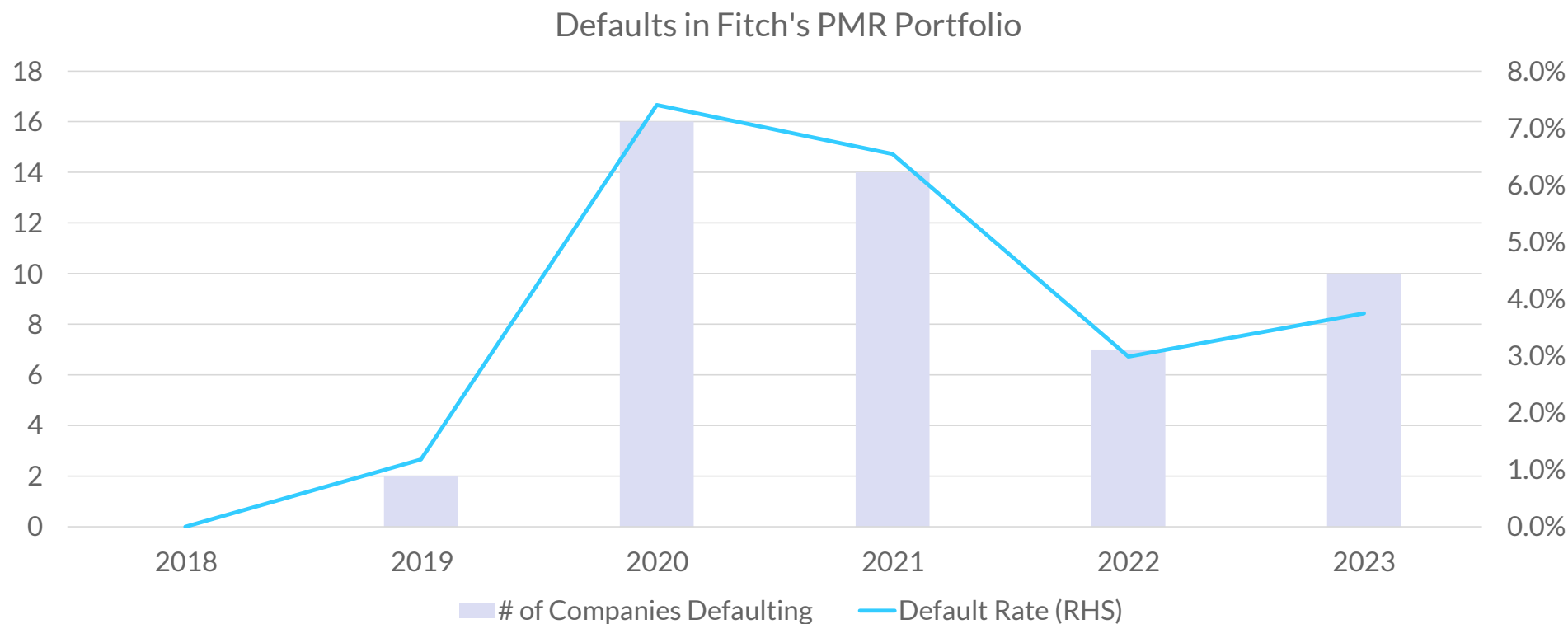
Median leverage for Fitch's PMR portfolio has fallen from a peak of 6.5x in 2021 and is expected to fall further



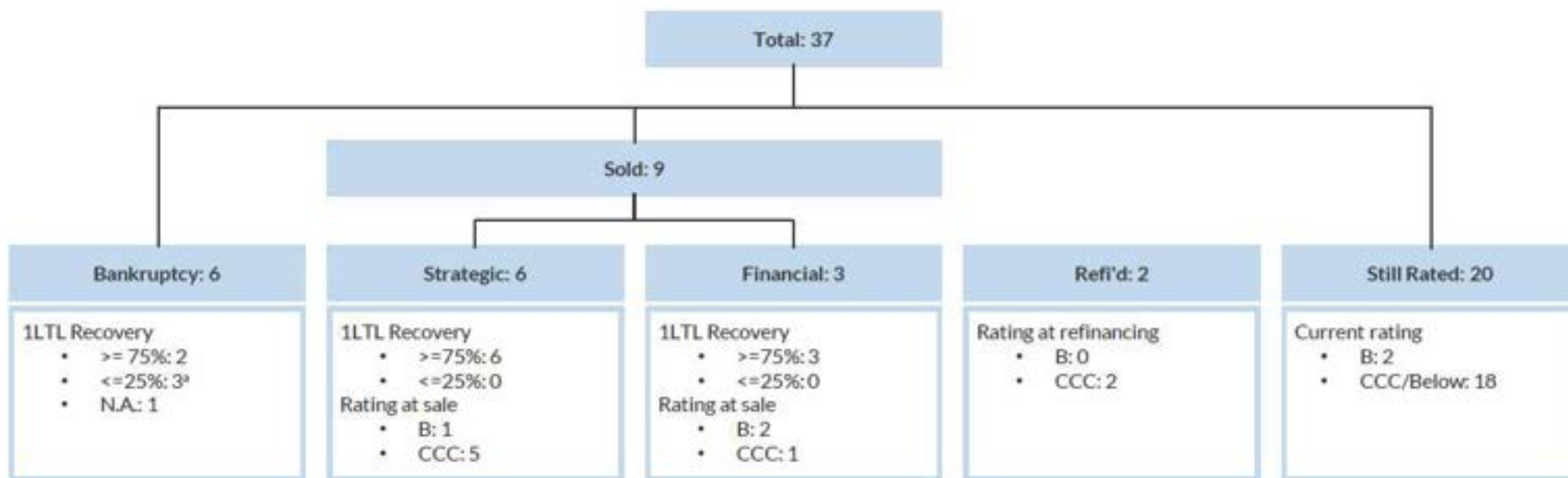
Fund leverage remains manageable at a little less than 1.3x as of the end of 2021



Defaults Rise in More Adverse Economic Scenario



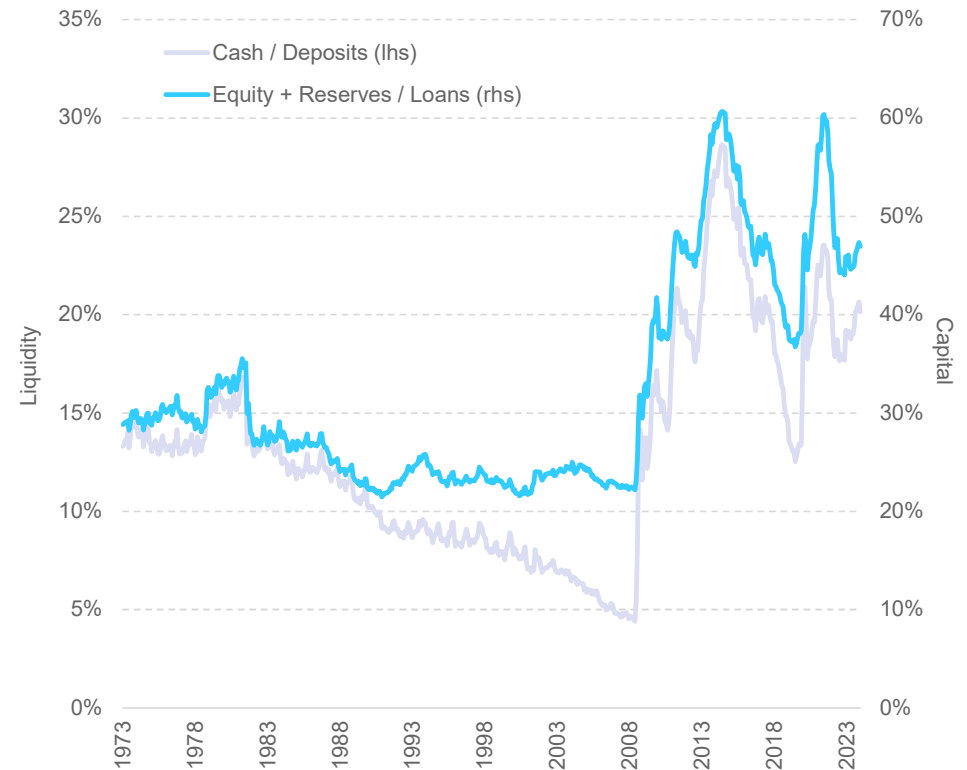
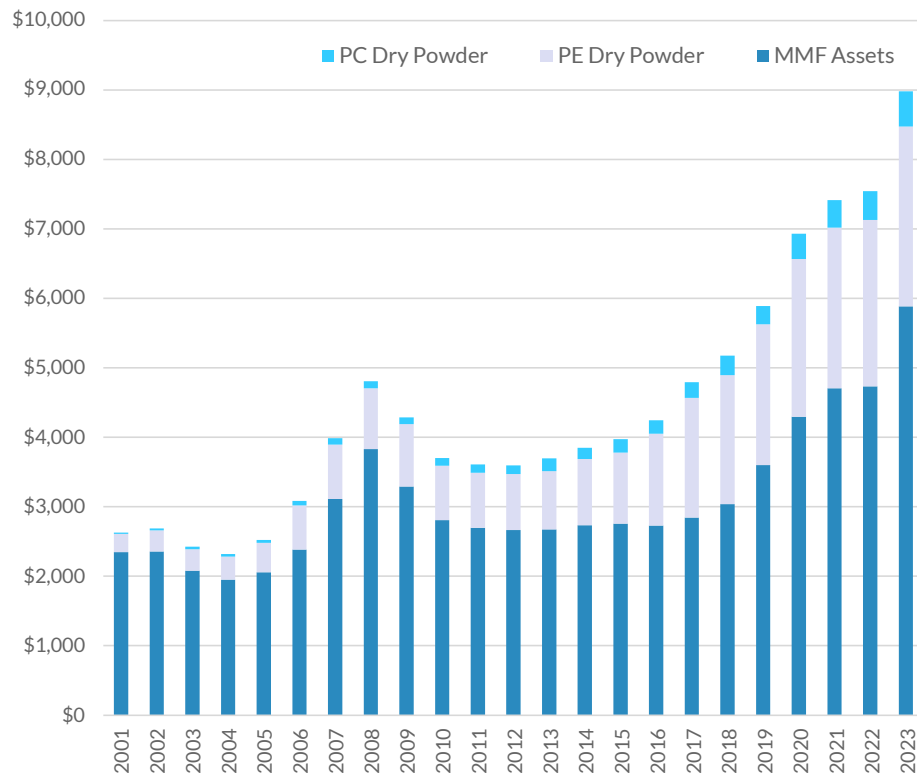
Default Outcomes are Bifurcated



*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.

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.



This Report is for informational purposes only. Neither the information contained in this Report, nor any opinion expressed therein is intended as an offer or solicitation with respect to the purchase or sale of any security or as personalized investment advice. CreditSights and its affiliates do not recommend the purchase or sale of financial products or securities, and do not give investment advice or provide any legal, auditing, accounting, appraisal, valuation or actuarial services. Neither CreditSights nor the persons involved in preparing this Report or their respective households has a financial interest in the securities discussed herein. Recommendations made in a report may not be suitable for all investors and do not take into account any particular user's investment risk tolerance, return objectives, asset allocation, investment horizon, or any other factors or constraints.

Information included in any article that includes analysis of documents, agreements, controversies, or proceedings is for informational purposes only and does not constitute legal advice. No attorney client relationship is created between any reader and CreditSights as a result of the publication of any research report, or any response provided by CreditSights (including, but not limited to, the ask an analyst feature or any other analyst interaction) or as the result of the payment to CreditSights of subscription fees. The material included in an article may not reflect the most current legal developments. We disclaim all liability in respect to actions taken or not taken based on any or all the contents of any research report or communication to the fullest extent permitted by law.

Reproduction of this report, even for internal distribution, is strictly prohibited. Receipt and review of this research report constitutes your agreement not to redistribute, retransmit, or disclose to others the contents, opinions, conclusion or information contained in this report (including any investment recommendations or estimates) without first obtaining express permission from CreditSights. The information in this Report has been obtained from sources believed to be reliable; however, neither its accuracy, nor completeness, nor the opinions based thereon are guaranteed. The products are being provided to the user on an "as is" basis, exclusive of any express or implied warranty or representation of any kind, including as to the accuracy, timeliness, completeness, or merchantability or fitness for any particular purpose of the report or of any such information or data, or that the report will meet any user's requirements. CreditSights may issue or may have issued other reports that are inconsistent with or may reach different conclusions than those represented in this Report, and all opinions are reflective of judgments made on the original date of publication. CreditSights is under no obligation to ensure that other reports are brought to the attention of any recipient of the Products.

Certain data appearing herein is owned by, and used under license from, certain third parties. Please see Legal Notices for important information and limitations regarding such data. For terms of use, see Terms & Conditions.

If you have any questions regarding the contents of this report contact CreditSights at legal@creditsights.com.

© 2023. CreditSights, Inc. All rights reserved.