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Private Credit: Overview and Update on Investor Trends

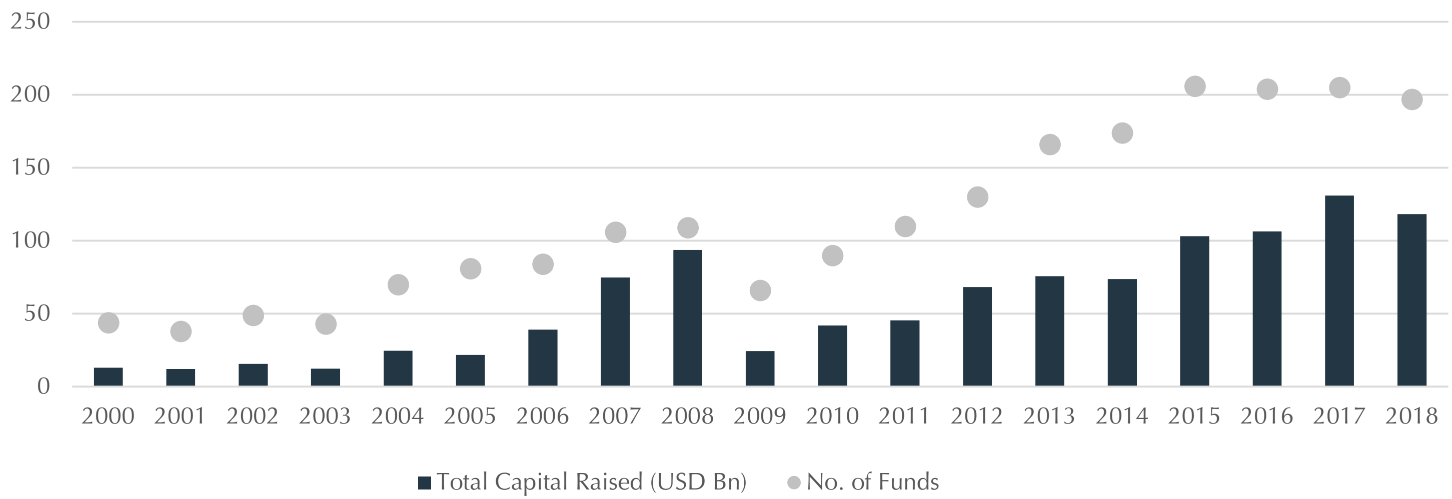
Private Credit

Primary motivations:

- Potential enhanced yields over public credit due to illiquidity and complexity premium
- Exposure to strategy "diversifiers" via wide spectrum of underlying collateral types
- Income generation through contractual yield, usually floating rate based

At the same time, capital inflows remain strong:

- Private debt funds raised $118 billion in commitments in 2018 – the second most of any year on record[1]
- However, private credit is not without its issues. Investors cite the top 3 issues as: rising interest rates, pricing / valuations, and competition for assets[2]



Source: Preqin Data, as of June 24, 2019

1. Preqin Data, as of June 24, 2019
2. 2019 Preqin Global Private Debt Report

Defining Private Credit - Spectrum of Strategies

Direct Lending

U.S. Direct Lending
- Senior
- Opportunistic
- LMM (sponsored)
- LMM (non-sponsored)
- Private BDCs
- Industry Focused
- SBIC
- Revolvers

European Direct Lending
- Senior
- Opportunistic
- Lower Middle Market
- Country-Specific Funds

Emerging Markets Lending
- Asian
- African
- CEE/Middle East
- Latin American
- Pan-EM

Global Direct Lending
- Global

Mezzanine

U.S. Mezzanine
- Upper Middle Market
- Middle Market
- Lower Middle Market

European Mezzanine
- European Mezzanine

Structured Equity
- Structured Equity

Distressed & Special Situations

Corporate Distressed
- U.S.
- European
- Emerging Markets
- Global
- Single Trade

Real Estate Distressed
- U.S.
- European
- Global

Special Situations
- U.S.
- European
- Emerging Markets
- Global

Specialty Finance

Consumer & SME Lending
- Marketplace Finance
- Lender/Platform Finance

Factoring & Receivables
- Factoring & Receivables

Regulatory Capital Relief
- Regulatory Capital Relief

Royalties
- Healthcare
- Music/Film/Media
- Energy & Minerals
- Royalties

Healthcare Lending
- Healthcare Lending

Venture Lending
- Venture Lending

Insurance Linked
- Diversified
- Life
- Non-Life

Litigation Finance
- Litigation Finance

Merger Appraisal Rights
- Merger Appraisal Rights

PE Portfolio Finance
- PE Portfolio Finance

Structured Credit

CLO
- CLO Debt
- CLO Multi
- Captive CLO Equity
- 3rd Party CLO Equity

CRE
- Non-Agency CRE B-Piece
- Agency CRE B-Piece
- CMBS/CRE

RMBS
- RMBS

Consumer ABS
- Consumer ABS

Esoteric ABS
- Esoteric ABS

Europe Structured Credit
- European Structured Credit

Structured Credit Multi-Sector
- Structured Credit Multi-Sector

Real Estate Credit

U.S. CRE Core Lending
- U.S. CRE Core Lending

U.S. CRE Transitional Lending
- Large Loan
- Middle Market
- Small Balance
- Opportunistic

U.S. CRE Bridge Lending
- Large Loan
- Middle Market
- Small Balance

European CRE Lending
- Bridge
- Transitional
- Core

EM CRE Lending
- EM CRE Lending

Residential Mortgages
- Residential NPLs
- Single Family Rental
- Mortgage Servicing Rights
- Residential Origination

Real Assets Credit

Infrastructure Lending
- Senior Focus
- Sub-IG Focus
- Mezz Focus

Energy Credit
- Energy Lending
- Energy Mezzanine Lending
- Opportunistic

Trade Finance
- Trade Finance

Metals & Mining Finance
- Metals & Mining Finance

Agricultural Credit
- Agricultural Credit

Transportation
- Aviation Lending
- Maritime Lending
- Road & Rail Lending
- Diversified Transportation Lending

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Private Credit – At a Glance

Underlying Asset Types	Corporate, real estate, real assets, consumer
Fund/Investment Structures	Private equity style, draw-down vehicles, custom vehicles, SMAs, co-investments
Status	Performing, non-performing
Capital Structure	ABL, senior CF, 2nd lien, mezz, structured
Yield	Typically paid floating-rate
Fund Term	Typically 4 to 8 years, excluding extensions
Management Fee	Commonly 1.0%-1.5%, typically paid on invested capital
Incentive Fee	Commonly 10% - 20% over a preferred return

Private Credit – Complementary to Traditional Allocations

Private Credit	vs. Private Equity	vs. High Yield Bonds	vs. Hedge Funds
Typical Benefits	- Typically lower fees / often paid on invested capital - J-Curve mitigation - Current yield - Shorter fund duration - Capital structure seniority - Less dispersion of returns / narrower range of outcomes	- Benefit from rising rates (floating rate) - Senior vs. subordinated - Yield pick-up from illiquidity premium - Less price volatility / technical-driven selling - Lower EBITDA leverage - Covenant protection	- Suitable structure for less liquid assets - Preferred return or hard hurdle - Improved transparency - Reduced investor adjacency risk - Reduced cash performance drag - Less whipsaw risk
Typical Drawbacks	- Lower expected returns / upside is capped - GP track record duration often limited - Less operational control	- Less liquidity - Slower capital deployment - Less market transparency - Smaller issuers - Higher fees	- Less liquidity - No ability to short - Less able to pivot with opportunity

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Approaches to Portfolio Construction

Fixed Income Substitute:

Diversified positions in senior lending strategies - often a combination of corporate and real estate debt GPs

- Direct Lending
- Real Estate
- Real Assets Lending

Core + Satellite:

Concentrated positions in direct lending and/or cross asset complemented with smaller holdings in specialized GPs

Core

- Direct Lending *(mostly senior US and Europe)*
- Cross Asset/ Special Situations

Satellite

- Structured Credit
- Specialty Finance
- Real Estate Credit
- Real Assets Credit
- Mezzanine

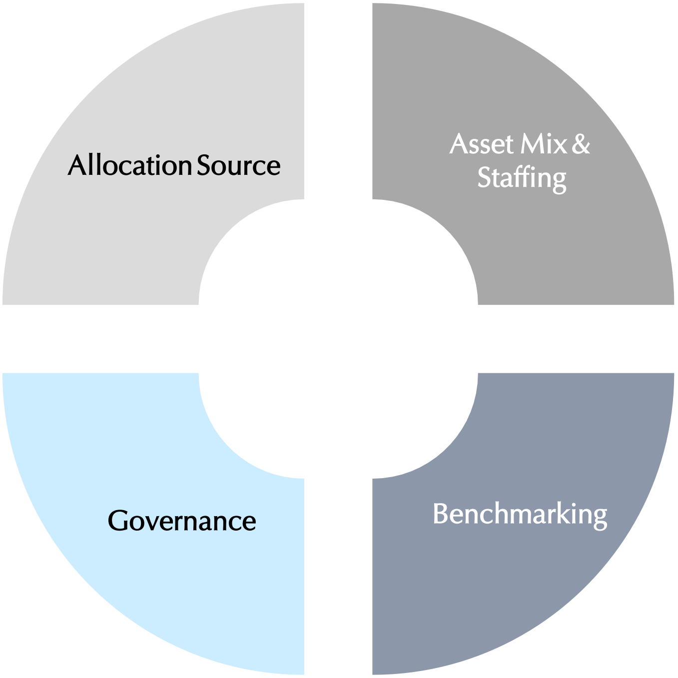
Opportunistic:

Diversified across various collateral types with a bias towards niche opportunities

- Direct Lending
- Distressed & Special Situations
- Structured Credit
- Specialty Finance
- Real Estate Credit
- Real Assets Credit
- Mezzanine

Implementation Challenges

- Where should the source of allocation come from (e.g., high yield, private equity, hedge funds, other)?



- What asset types will it include? (e.g., real estate, corporate, real assets?)
- Who at the organization should manage (i.e., Fixed Income, PE, Absolute Return, Team effort)?

- How are investment decisions made?
- Who has the ultimate signoff?

- How should it be measured/ benchmarked (i.e., high yield index, levered loan index, LIBOR + spread, custom mix)?

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