# Private Credit: Market Uncertainty May Create a Historic Opportunity

With interest rates high, increased market volatility and banking sector stress, the loan market has quickly shifted to favoring private credit. This may create a historic opportunity for investors to allocate part of their investment portfolio to the asset class.

For more than a decade, historically low interest rates meant easy money for borrowers but challenges for lenders, who faced compressed profit margins. Recent U.S. Federal Reserve (Fed) rate hikes, spurred by persistent inflation, have changed that equation. Now, many banks are de-risking balance sheets and struggling to extend new loans at a time when they are overwhelmed by applications for credit from corporations and private equity sponsors, and private equity "dry powder" is near record levels.

This has important implications:

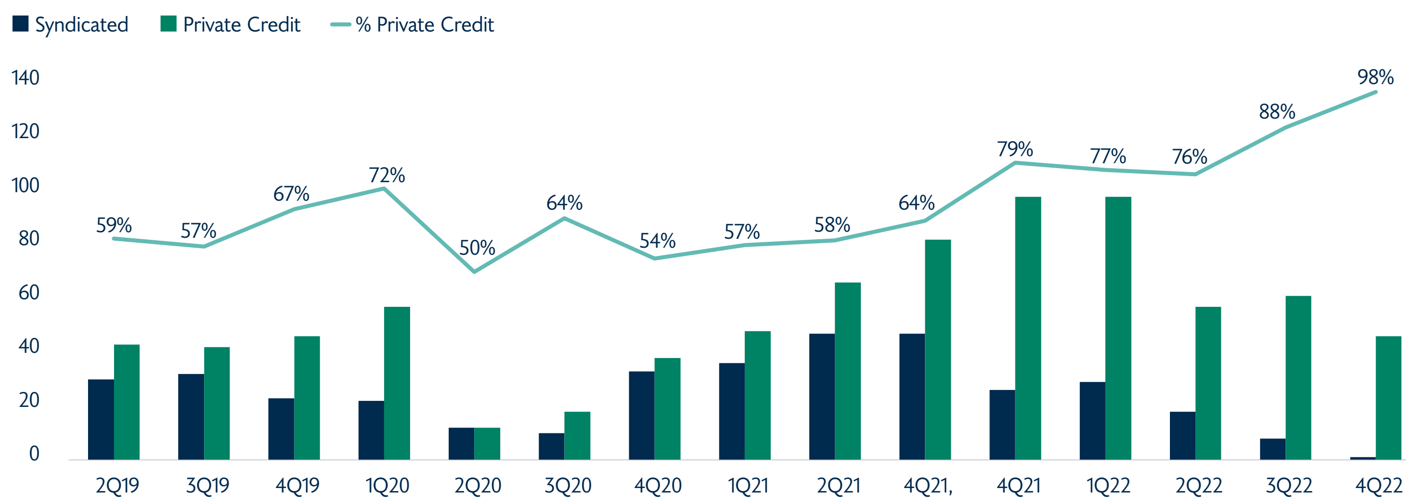
- There could be new opportunities for lenders with healthy portfolios and abundant capital.
- These lenders may be able to demand improved deal terms and structures.

## Bank Lending Opens the Door for Private Lenders

In late 2021, syndicated bank lending for leveraged buyouts (LBOs) started slowing, and when the Fed began hiking rates in 2022 (**Figure 1**), it came close to a halt. Private lenders stepped into the breach, funding nearly all LBO activity starting in the fourth quarter of 2022.

### Figure 1: Syndicated Lending Has Stalled, Opening an Opportunity for Private Credit

Number of LBOs Financed by Syndicated Loans vs. Percentage Financed by Private Credit




Source: Pitchbook LCD. Data as of December 31, 2022.

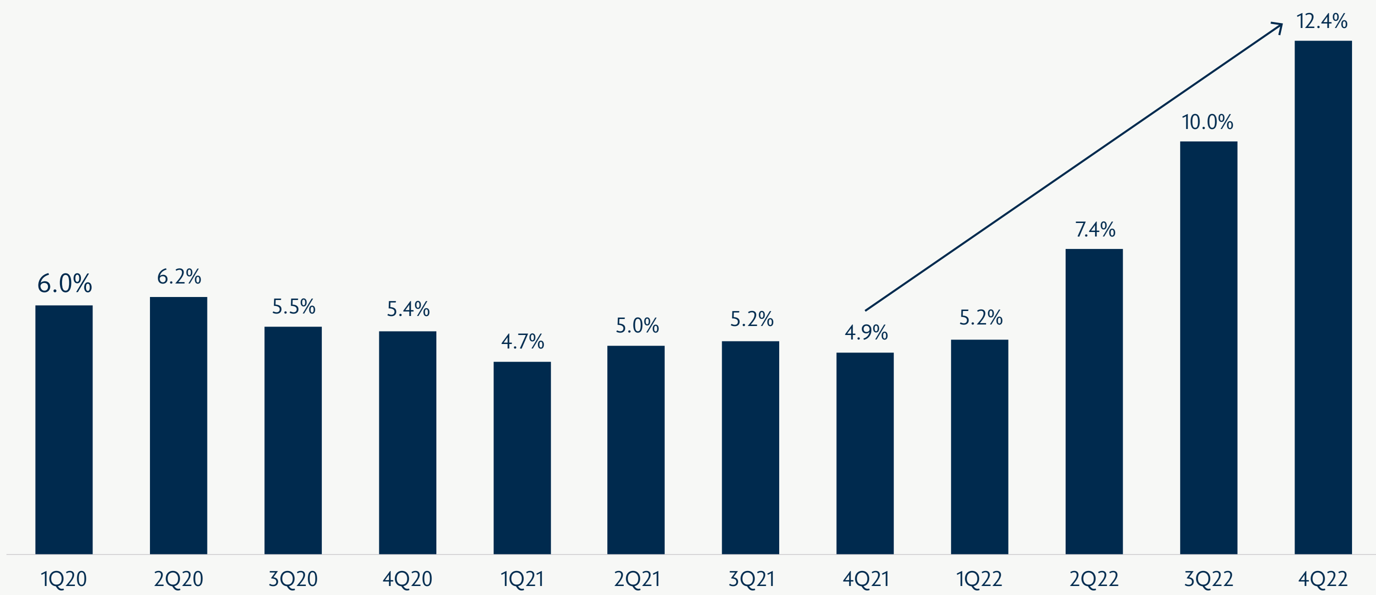
Note: Private credit count based on transactions covered by LCD News. LBOs are leveraged buyouts.

Conditions have since deteriorated further. Broad market weakness in 2022 left banks with roughly $80 billion in underwritten loans they could not syndicate. They are also saddled with billions of dollars in "hung" loans—bridge financing, typically for an acquisition, that was not refinanced. Now, banks seeking to unload debt must do so at a discount, generating losses. It will take time for banks to regain their ability, and willingness, to underwrite large buyout loans.

At the same time, there is strong demand for credit. Private equity sponsors and companies that are already highly leveraged are competing for increasingly scarce and expensive capital.

Private lenders are filling the void at more favorable terms. The mix of high interest rates and tightening credit conditions means that sponsors are paying significantly more for debt financing. As shown in **Figure 2**, at the end of 2022 first-lien private credit deals offered attractive coupons of 12.4%.

## Figure 2: Average Yield on Large LBO Loans Has Increased Sharply




**Past performance does not guarantee future results**. The data herein are presented for illustrative purposes only and do not predict or depict the performance of any investment.

Source: Pitchbook LCD. Data as of December 31, 2022.

Note: Based on transactions greater than $1 billion from 2019-2022. Large LBO loans defined as $50 million or more of Earnings Before Interest, Taxes, Depreciation and Amortization.

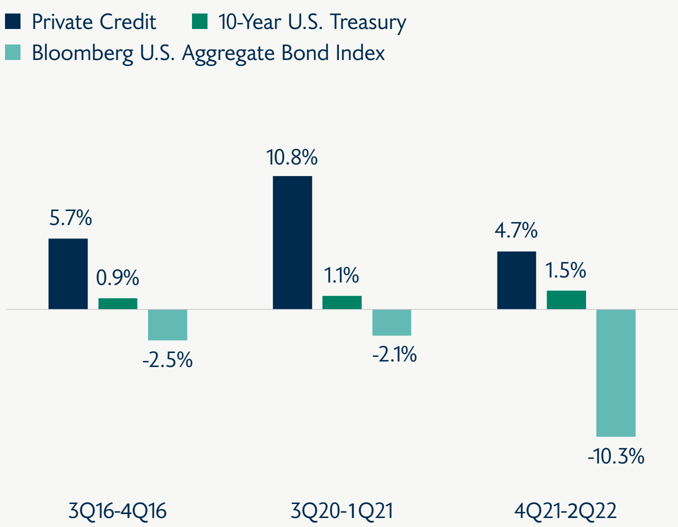
Additionally, falling valuations mean that LBO sponsors require less leverage to get deals done, resulting in loan-to-value (LTV) ratios[1] that have fallen from 60-70% a year ago to 40-50%.[2] We believe these loans should also be less risky because lenders can negotiate stronger covenants.

## Potential Benefits of Investing in Private Credit

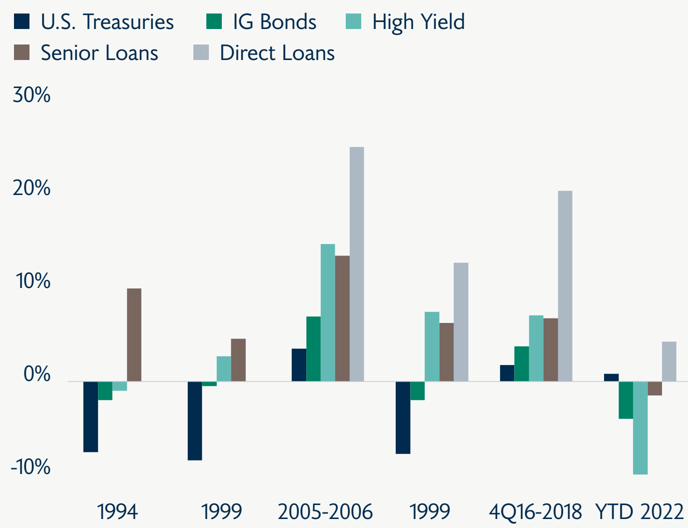
For investors, adding private credit to an investment portfolio can be beneficial when interest rates are rising. The graphic below shows that private credit has outperformed 10-year U.S. Treasuries, and the broader bond market, during periods when yields had risen by at least 75 basis points. Historically, rising interest rates have buoyed that strong performance thanks to the floating-rate nature of private credit (**Figure 3**).

### Figure 3: Floating-Rate Private Credit Has Historically Outperformed Amid Rising Rates

By the End of 2022, Leverage Multiples Surpassed Pre-2008 Levels …[3]




… and Covenant-Lite Loan Terms Had Become the Norm[4]

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Indices are not actively managed, and investors cannot invest directly in indices. All investments involve risk of loss, including loss of principal invested.

Source: Morningstar, U.S. Federal Reserve, Bloomberg, ICE BofA, FTSE 10-Year Treasury, Credit Suisse, Refinitiv LPC, Cliffwater. Data as of June 30, 2022 (left chart), September 30, 2022 (right chart).

Right chart depicts performance during periods when U.S. 10-year Treasury yields rose 0.75% or more over five years, beginning in 2016. Private Credit represented by Cliffwater Direct Lending Index. Data as of June 30, 2022.

Left chart shows performance over last six rate cycles through June 2022. Investment Grade represented by ICE BofA Global Corporate Bond Index, U.S. High Yield by ICE BofA Index, Senior Loans by Credit Suisse Leveraged Loan Index, Direct Loans by Cliffwater Direct Lending Index (data since index inception in 2005, as of September 30, 2022). Reflects cumulative returns.

## The Time May Be Right for Investors to Allocate to Private Credit

In our view, investors seeking to allocate to private credit should consider looking for investment managers who prioritize risk management, have been active in private credit over multiple cycles, and have a track record of delivering robust performance. These firms tend to be easy to recognize because they resisted the allure of low-rate covenant-lite loans, avoided major problems in their portfolios and can now capitalize on this historic opportunity.

We believe the direct lending opportunity is currently as attractive as at any time in recent history. In the words of Oaktree Capital co-founder Howard Marks, “In my 53 years in the investment world, I’ve seen a number of economic cycles, pendulum swings, manias and panics, bubbles and crashes, but I remember only two real sea changes. I think we may be in the midst of a third one today.”

## ENDNOTES

[1] LTV is an important metric that helps gauge lending risk, calculated by dividing the loan size by the value of the underlying asset. Generally, the higher the LTV, the riskier a loan is considered.

[2] Pitchbook LCD, as of February 28, 2023.

[3] Chart depicts performance during periods when U.S. 10-year Treasury yields rose by 0.75% or more over 5 years, beginning in 2016. Private Credit represented by the Cliffwater Direct Lending Index. Data as of June 30, 2022.

[4] Chart shows performance over last six interest rate cycles through November 2022. IG Bonds (investment-grade bonds) represented by ICE BofA Global Corporate Bond Index, U.S. High Yield by ICE BofA Index, Senior Loans by Credit Suisse Leveraged Loan Index, Direct Loans by Cliffwater Direct Lending Index (data since index inception in 2005, as of September 30, 2022). Reflects cumulative returns.

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As an asset class, private credit is comprised of a large variety of different debt instruments. While each has its own risk and return profile, private credit assets generally have increased risk of default, due to their typical opportunistic focus on companies with limited funding options, in comparison to their public equivalents.

Because private credit usually involves lending to below investment grade or non-rated issuers, yield on private credit assets is increased in return for taking on increased risk.

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**Investment Grade:** The ICE BofA US Corporate Bond Index tracks the performance of U.S. dollar-denominated investment-grade corporate debt publicly issued in the U.S. domestic market. Index constituents are market-capitalization-weighted.

**Private Credit:** The Cliffwater Direct Lending Index measures the unlevered, gross-of-fees performance of U.S. middle-market corporate loans, as represented by the asset-weighted performance of the underlying assets of business development companies (BDCs), including both exchange-traded and unlisted BDCs, subject to certain eligibility requirements.

**Senior Loans:** The Credit Suisse Leveraged Loan Index is designed to mirror the investable universe of the U.S. dollar-denominated leveraged loan market. The index includes only those loans rated "5B" or lower, or if unrated, the initial spread level must be Libor plus 125 basis points or higher. The index includes only funded loans with a tenor of at least one year.

**U.S. Treasuries:** The ICE BofA U.S. Treasury Index is a subset of the Bank of America Treasury Master Index. The index measures the total-return performance of U.S. Treasury bonds with an outstanding par that is greater than or equal to $25 million.

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