The Alts Institute

Private Credit Demystified

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WEALTH SOLUTIONS

Overview

Private credit has seen remarkable growth over the past several decades—a trend that has gathered pace and we believe shows no signs of slowing. The asset class has grown from just $0.4 trillion in 2010 to nearly $1.5 trillion today and is projected to reach $2.6 trillion by 2029.[1]

Despite its growing prominence in investing conversations, private credit is often misunderstood. Simply put, private credit refers to loans made directly to a borrower from a non-bank lender. It's essentially a way to provide debt financing to borrowers who are unable to access traditional bank loans or public markets, typically due to the nature or size of their businesses.

In this piece, we aim to demystify private credit as an asset class. We'll explore private credit characteristics and the various private market strategies. We'll also discuss the reasons behind private credit growth, why it's expected to continue on its growth trajectory, and the ways an allocation to private credit can potentially benefit a portfolio.

CONTENTS

What Is Private Credit?

Private credit is the origination of a bilateral loan without a traditional bank intermediary connecting the borrower directly to the private lender (**Figure 1**). Unlike public debt instruments such as investment grade or high yield bonds, private credit is non-rated.

Figure 1: Private Credit Defined

For illustrative purposes only.

Private credit is a solution for borrowers who typically lack access to traditional bank lending or public markets. This can be the case for middle-market businesses,[2] where banks prefer more lucrative lending to only the largest corporate borrowers. Niche businesses can also face challenges in obtaining bank loans, as their business model or industry may require specialized underwriting expertise that can be difficult for banks to understand or value properly.

Private Credit's Distinctive Characteristics

Although private credit can involve varied assets and industries, it generally shares several characteristics.

Floating-rate coupons: Private loan interest rates are normally quoted as a spread above a reference rate, such as the Secured Overnight Financing Rate (SOFR), and move in lock step with interest rates.

Short terms to maturity: The average term to maturity of these loans is between five and six years, compared with over seven years for high yield bonds.

Potential to negotiate strong covenants: Private loan agreements often include negative and affirmative covenants that are designed to restrict the borrower from actions such as taking on more debt. They can also require the borrower to maintain specific leverage and interest-coverage metrics. By comparison, broadly syndicated loans are "cov-lite" or come with no such protections.

Less liquidity: Lenders can't move in and out of these investments as easily as investors can normally buy and sell broadly syndicated loans and high yield bonds. However, lenders are typically compensated for this risk with the possibility of a higher rate of return—also called the illiquidity premium.

Low correlation to public markets: Because private credit is non-traded and direct lending deals are bespoke in nature, returns are typically not highly correlated with those of public debt and equity markets, and volatility tends to be lower.

Private Credit Strategies

Common private credit strategies include everything from mezzanine financing to distressed debt (**Figure 2**). The most common form among these is direct lending.

Figure 2: Common Private Credit Strategies

Direct lending	Mezzanine financing	Asset-backed finance	Opportunistic lending	Distressed debt
Senior debt issued to founder-owned or private equity-owned businesses, often to assist with growth capital	Junior debt situated between senior debt and equity, often used to finance leveraged buyouts, recapitalizations and corporate acquisitions	Specialty lending where the loan is collateralized by the company's assets, cash or receivables	Lending to stable companies with acute financing needs (e.g., liquidity or maturities)	Discounted financing to companies facing financial distress, such as possible insolvency, or bankruptcy
EXAMPLE Flexible financing solution to private equity sponsor firm to support its acquisition of a personal-care products company	**EXAMPLE** Founder-owned tech firm seeking to expand obtains financing that includes a combination of interest payments and convertible warrants	**EXAMPLE** A bespoke loan to a dental device company secured by the company's existing inventory and proprietary manufacturing equipment	**EXAMPLE** First lien term "rescue" loan to an energy company with long-term stability that has been temporarily impacted by cyclical headwinds	**EXAMPLE** Lender helps fundamentally sound retail company with bad balance sheet emerge successfully from bankruptcy restructuring

When it comes to access, these private credit strategies were once only available to the largest institutional investors. But retail investor demand has spurred the development of new vehicles and solutions such that private credit is now more accessible to a broader range of investors, including individual investors.

What's Behind the Rise of Private Credit?

The private credit market has grown exponentially over the last several decades and now represents $1.5 trillion in assets. The trend has accelerated since the aftermath of the Global Financial Crisis (GFC), with 319% growth in the private credit market from 2010 to today.[3]

The story of private credit's rise starts in the 1980s, when the advent of the high yield bond market provided lending solutions for many small to medium-sized companies with below investment grade credit ratings. However, the high yield bond market proved an imperfect solution, as it came with high bank access costs, extensive regulatory disclosure requirements, and often prohibitive issuance size minimums.

As these inefficiencies presented barriers to the high yield market for many smaller, primarily private equity-owned companies, they turned to private credit solutions—spurring considerable private credit market growth. This trend coincided with the decline of banks engaging in middle-market lending in the 1990s, as regional U.S. banks began consolidating. The resulting larger banks focused less on lending to middle-market companies and more on fee-based business lines and financings for larger firms.

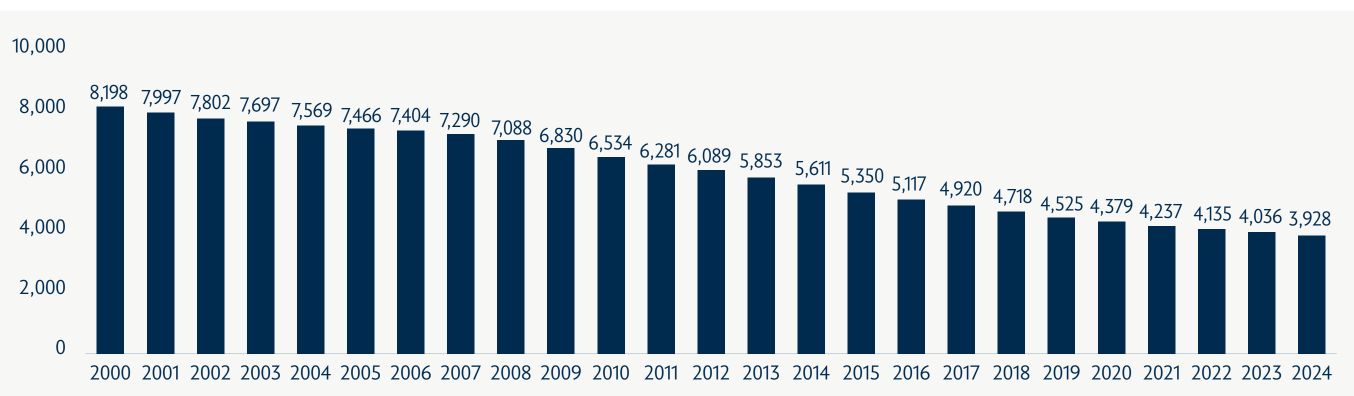
Fast forward to the post-GFC era, when Dodd-Frank Wall Street Reform and the Consumer Protection Act were passed, introducing enhanced rules and regulatory requirements that intensified underwriting standards and mandated that banks hold additional capital against assets. The increased regulation and balance sheet scrutiny led more banks to focus on lending to only the largest borrowers.

This left a tremendous opportunity for private lenders to step in and fill the void for mid-sized companies in need of financing solutions, especially those with riskier credit profiles or harder-to-understand balance sheets. As a result, bank lending declined while non-bank lending rose.

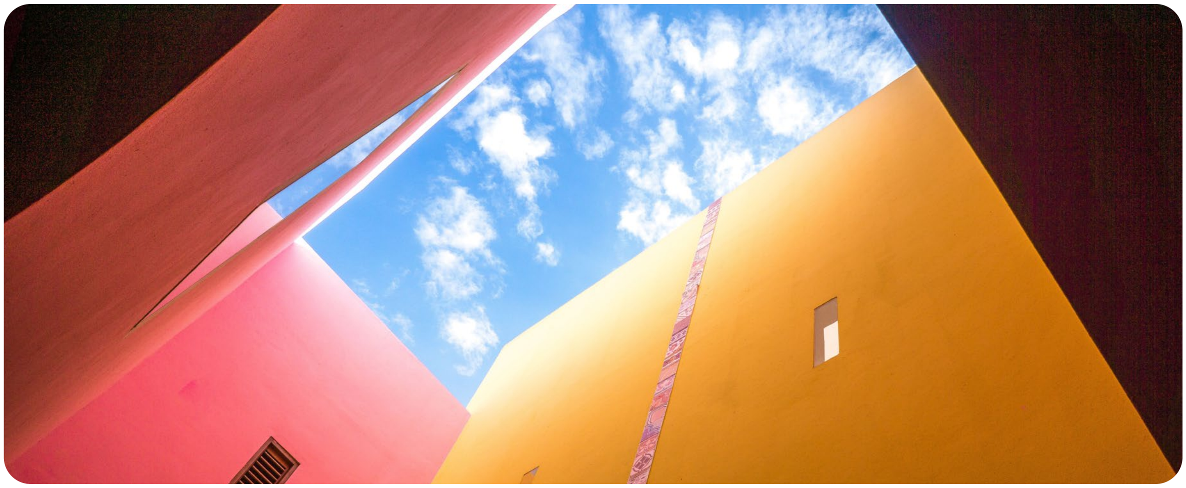
The regional U.S. bank consolidation trend that started decades ago has extended to the present day, further expanding the private credit opportunity (**Figure 3**). In addition, the regional bank crisis that peaked in early 2023 resulted in more regulatory reform proposals designed to strengthen large U.S. bank oversight. In the face of a second wave of regulation, more banks could turn away middle-market lending opportunities—and more borrowers could turn to private lenders.

Figure 3: Bank Consolidation Continues to Shift the Lending Landscape

Total number of U.S. commercial banks



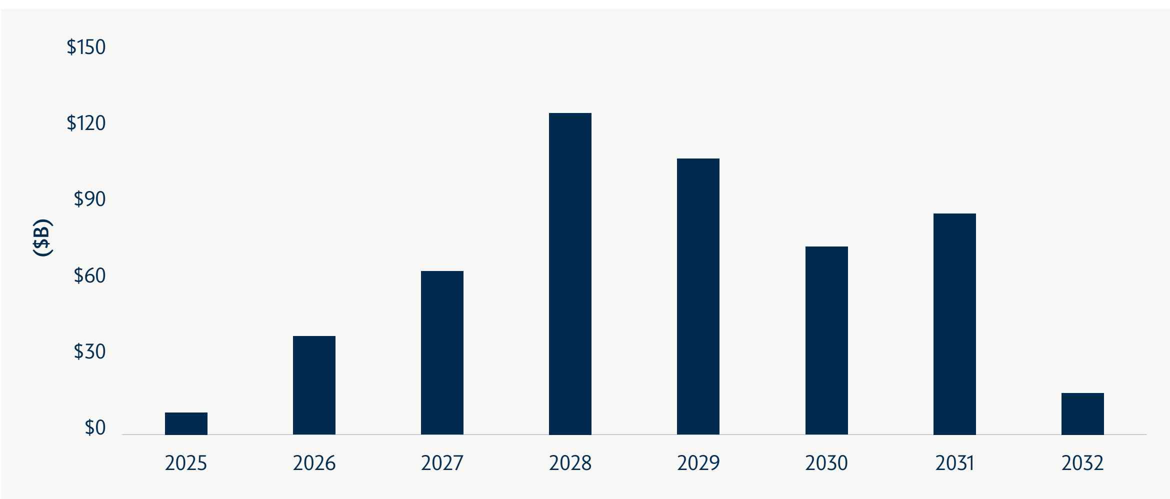
Source: FDIC, as of December 31, 2024.



Another potential private credit market growth driver is the looming debt maturity wall: over $120 billion in middle-market debt is scheduled to mature in 2028 alone. Amid a higher interest rate environment, middle-market companies in many regions will likely require significant refinancing capital (**Figure 4**).

Figure 4: Substantial Amount of Debt Maturing in Next Several Years May Increase Demand for Private Credit Solutions

Middle-market senior debt maturity wall



Source: KBRA DLD. As of March 31, 2025. *KBRA DLD's U.S. Private Data* library totals $764 billion.

Record amounts of private equity dry powder could be an additional tailwind for private credit demand. Current dry powder levels indicate private equity sponsors have a huge supply available to deploy—and they often use debt to finance their acquisitions. In fact, the leveraged buyout (LBO) debt funding need exceeds private credit dry powder by $2.9 trillion,[4] representing a remarkably wide funding gap. Private credit is poised to play a significant role in closing this gap, as it continues to capture market share by offering speed, certainty of execution, and the potential to extend large amounts of credit to a variety of borrowers.

Why Private Credit?

Private credit's unique characteristics can make for an alternative investment that's not only stable but also offers several potential benefits.

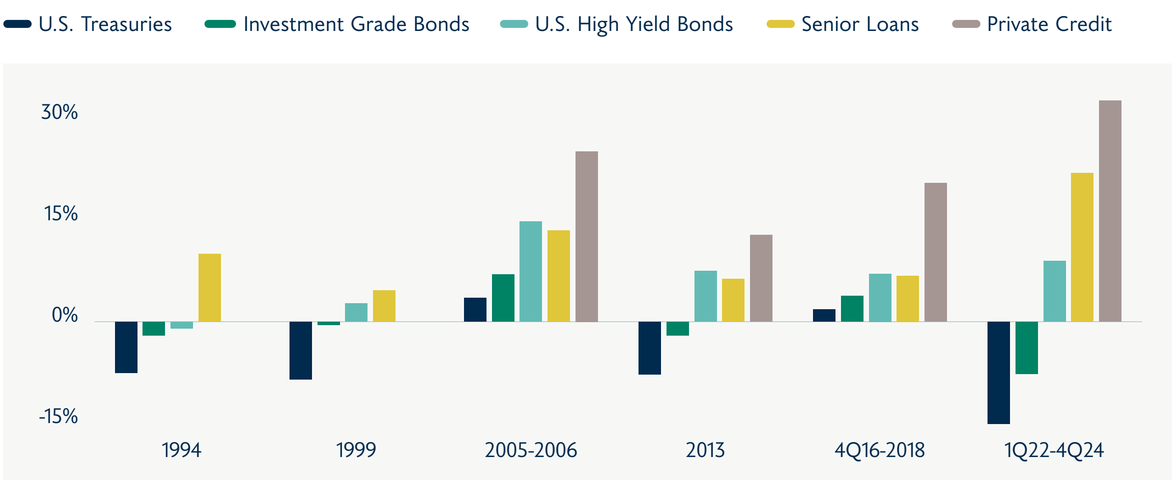
1. Minimize rising rate risk

The interest rate environment has been a growth driver for private credit in the past—and the new regime could spur more growth in the future. The prolonged low interest rate environment that followed the GFC resulted in historic low yields for traditional fixed income assets, where discerning investors turned to the private markets in search of yield—and discovered private credit's potential to deliver higher yields.

Investors can turn to private credit in today's "higher for longer" rate environment for different reasons. While private credit can provide a reliable source of yield in a low interest rate environment, it can also serve as a valuable hedge against the impact of rate increases. Private loans have shorter duration—or less sensitivity to interest rate changes—than fixed-rate debt. As rates move higher, so too does the private loan's interest rate. As a result, private loans don't decline in value amid rising rates. This potential benefit is evident when comparing private credit total returns with fixed-rate debt instruments over the last six rising rate cycles (**Figure 5**).

Figure 5: Private Credit Has Performed Well Historically Amid Rising Interest Rates

Total return % in the last six interest rate cycles



Past performance is not indicative of future results. Chart shows performance over last six interest rate cycles through June 2023. Treasuries represented by FTSE 10-Year Treasury, Investment Grade Bonds (investment-grade bonds) by ICE BofA Global Corporate Bond Index, High Yield Bonds by ICE BofA Index, Senior Loans by S&P UBS Leveraged Loan Index, Private Credit by the Cliffwater Direct Lending Index (data since index inception in 2005). Reflects cumulative returns. See disclosures for full index definitions. Indexes are unmanaged and cannot be purchased directly by investors. Index performance shown for illustrative purposes only and does not predict or depict the performance of any investment.

Source: Bloomberg, Credit Suisse, Cliffwater. As of December 31, 2024.

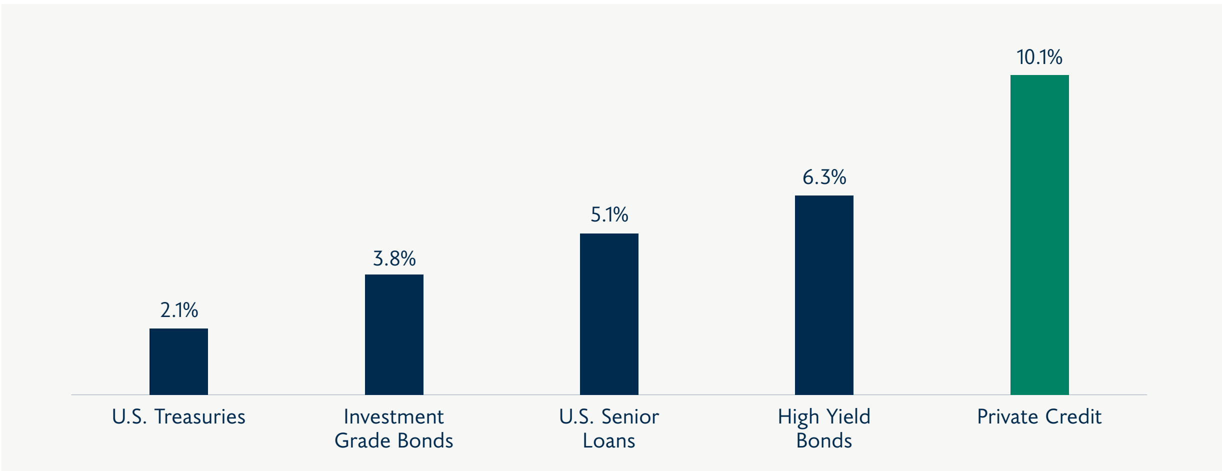
Private credit can also offer risk mitigation potential when rates decline. Loans can include call protection, which reduces prepayment risk by restricting borrowers from retiring loans within a few years of issuance, or prepayment penalties. Additionally, floating-rate loans typically have contracted floors on the reference rate, offering a buffer against falling rates.

2. Attractive long-term total returns

Direct lenders can often secure higher origination fees and coupon rates compared with investors in more liquid public debt investments. As a result, private credit has historically produced superior total returns relative to other fixed-income assets (**Figure 6**).

Figure 6: Private Credit Outperformed Traditional Fixed Income Over the Long-Term

Average annual total returns



Past performance is not indicative of future results. Information does not represent returns of a fund. An investor cannot invest in an index. For illustrative purposes only. U.S. Treasuries represented by FTSE 10-Year Treasury (OTR), Investment Grade Bonds represented by Bloomberg U.S. Corporate Bond Index, Senior Loans represented by S&P UBS Leveraged Loans Index, High-Yield Bonds represented by ICE BofA U.S. High-Yield Index, Private Credit represented by Cliffwater Direct Lending Index.

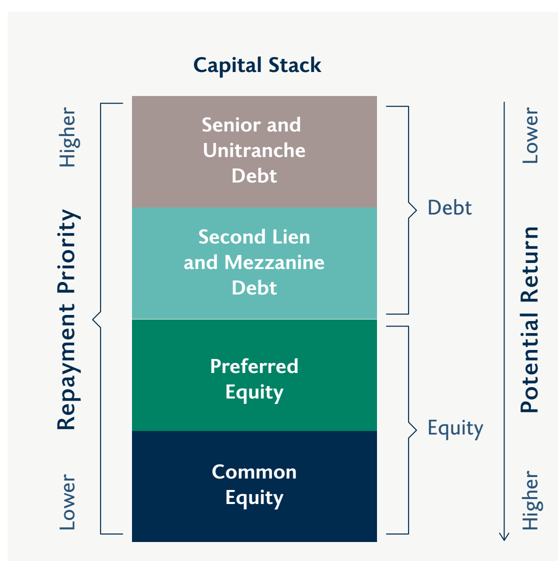
Source: Bloomberg, Cliffwater. January 1, 2010 through December 31, 2024.

3. Risk mitigation potential

Private loans are often secured by collateral and sit higher in a company's debt structure (**Figure 7**), meaning they're paid first in the event of a default. Lenders who hold senior debt generally have the initial claim on assets such as cash, accounts receivable, and equipment, while junior loans have subordinated claims but are still senior to bonds and equity. As such, private loans typically can help manage default risk.

Private loans also generally include the potential for greater lender protections than other debt instruments. They're not only high in the capital structure, but loan contracts typically include maintenance-based covenants, which are tested at regular intervals throughout the life of the loan. These lender protections require companies to meet certain financial conditions, which helps to keep their ratio of debt to EBITDA below a specific level.

Figure 7: Private Credit Is Higher in Repayment Priority With Equity

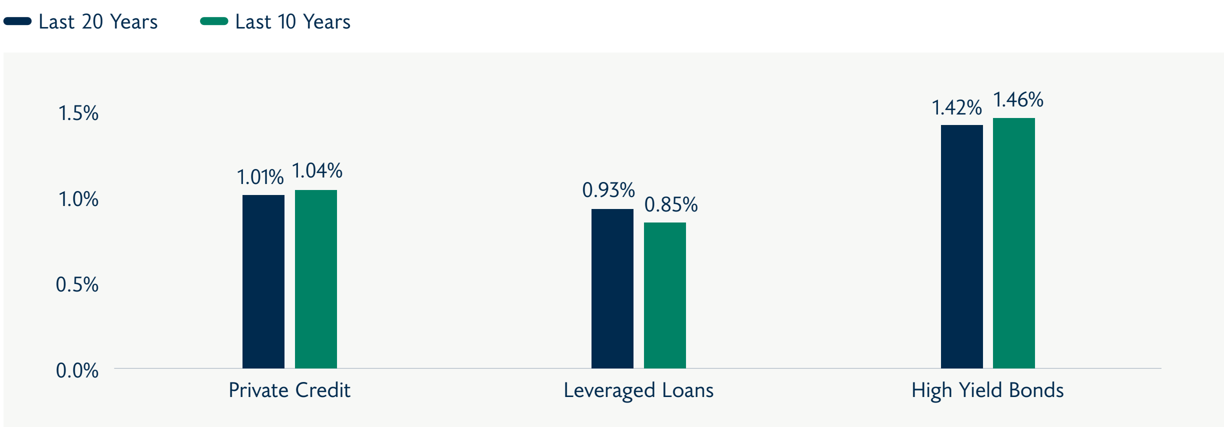


For illustrative purposes only.

A comparison of recovery rates across debt instruments demonstrates how private credit has historically offered strong risk mitigation potential. In the event of a default, private credit has historically realized fewer losses (**Figure 8**).

Figure 8: Private Credit's Historically Strong Risk Mitigation Potential Has Resulted in Low Losses

Average annual loss rate



Past performance is not indicative of future results. Calculations of losses include both interest income and principal gains and losses. Private Credit represented by Cliffwater Direct Lending Index (begins in 2004). Leveraged Loans represented by Credit Suisse Leveraged Loans Index from 2002 through 2014 and J.P. Morgan thereafter due to data availability. High-Yield Bonds represented by NYU Salomon Center/KBRA Altman from 2002 through 2022 and J.P. Morgan thereafter due to data availability.

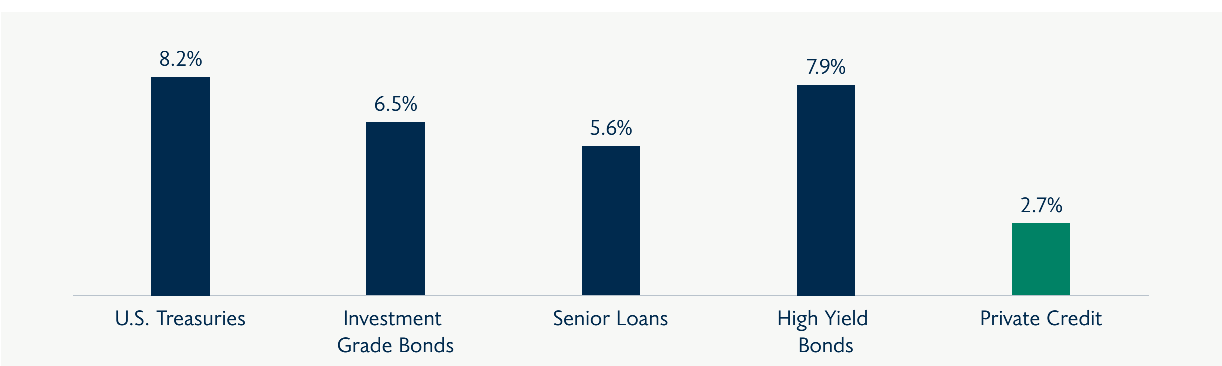
Source: JPMorgan Markets, Morningstar, Cliffwater. As of December 31, 2024.

4. Lower volatility

High yield bonds and other liquid debt instruments tend to be more volatile than the marked-to-market valuations of private credit investments. As shown, over the past two decades private credit has exhibited substantially lower volatility than more liquid debt instruments, thereby offering the potential to reduce portfolio risk (**Figure 9**).

Figure 9: Private Credit Can Offer Lower Volatility

Standard deviation



Past performance is not indicative of future results. U.S. Treasuries represented by FTSE 10-Year Treasury (OTR), Investment Grade Bonds represented by Bloomberg U.S. Corporate Bond Index, Senior Loans represented by S&P UBS Leveraged Loans Index, High-Yield Bonds represented by ICE BofA U.S. High-Yield Index, Private Credit represented by Cliffwater Direct Lending Index. Standard deviation, which represents volatility, measures the degree to which an investment's return varies from its mean return. See disclosures for full index definitions. Indexes are unmanaged and cannot be purchased directly by investors. Index performance shown for illustrative purposes only and does not predict or depict the performance of any investment.

Source: Bloomberg, Cliffwater. January 1, 2010 through December 31, 2024.

5. Enhanced diversification

Private loans have historically exhibited low correlations to traditional asset classes such as public debt and equities—and to the business cycle in general (**Figure 10**). This is in large part attributable to the breadth of the private lending universe, where lenders can access a diverse set of opportunities beyond the public markets. Middle-market companies can also be highly specialized within their industries, thereby reducing private credit intra-sector concentration risk.

Figure 10: Private Credit Exhibits Relatively Low Correlations With Other Asset Classes, Enhancing Diversification

Correlations

	Private Credit	High Yield Bonds	Senior Loans	Corporate Structured Credit	Emerging Markets Debt	U.S. Equities
Private Credit	1.00					
High Yield Bonds	0.50	1.00				
Senior Loans	0.60	0.83	1.00			
Corporate Structured Credit	0.48	0.69	0.84	1.00		
Emerging Markets Debt	0.45	0.89	0.81	0.72	1.00	
U.S. Equities	0.39	0.77	0.58	0.44	0.61	1.00

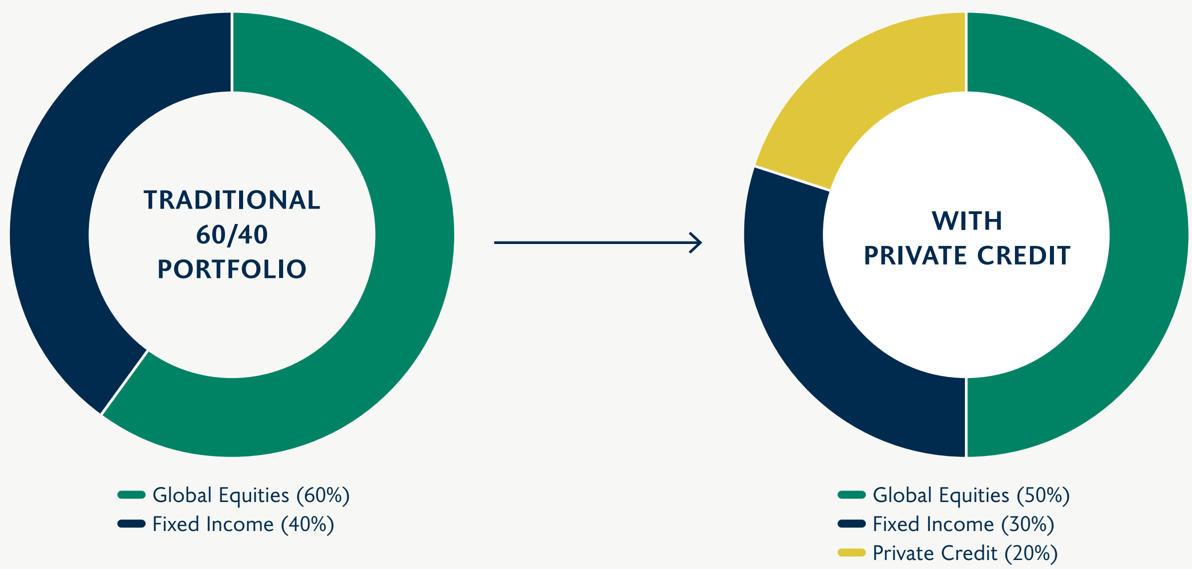
Past performance is not indicative of future results. Private Credit reflects Cliffwater Direct Lending Index, High Yield Bonds reflects ICE BofA Global High Yield Index, Senior Loans reflects S&P UBS Leveraged Loan Index, Corporate Structured Credit reflects JPMorgan CLO 2.0 BB Post-Crisis Index, Emerging Markets Debt reflects JPMorgan Corporate Broad CEMBI Diversified High Yield Index. U.S. Equities represented by S&P 500. See disclosures for full index definitions. Indexes are unmanaged and cannot be purchased directly by investors. Index performance shown for illustrative purposes only and does not predict or depict the performance of any investment.

Source: JPMorgan, ICE BofA, Credit Suisse, Bloomberg, Morningstar, Cliffwater. For the period January 1, 2013 through December 31, 2024.

With less direct correlation to the market, private credit can enhance diversification, providing both stability and growth, and adding a more balanced risk profile to a traditional portfolio (**Figure 11**).

Figure 11: Private Credit Can Enhance Portfolio Outcomes

Total return and risk



	Traditional 60/40 Portfolio	With Private Credit
Return	5.6%	6.5%
Volatility	12.0%	10.3%

Past performance is not indicative of future results. Diversification does not guarantee a profit or protect against loss. Equities refers to MSCI World Index, Fixed Income refers to the Bloomberg Global Aggregate Index, and Private Credit refers to the Cliffwater Direct Lending Index. See disclosures for full index definitions. Indexes are unmanaged and cannot be purchased directly by investors. Index performance shown for illustrative purposes only and does not predict or depict the performance of any investment. For the period from January 1, 2008 through December 31, 2023.

Source: Morningstar, Cliffwater.

What Are Private Credit Risks?

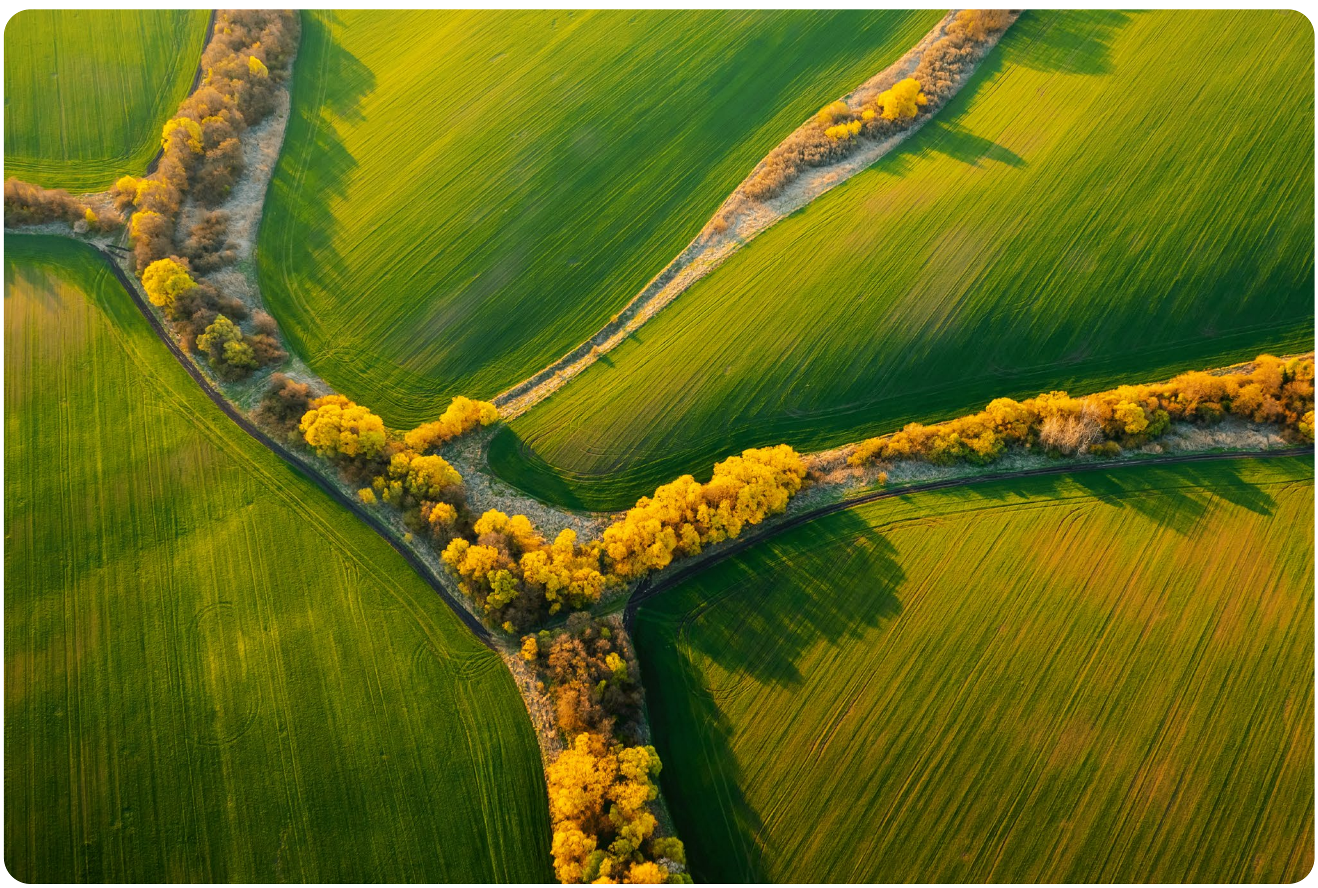
The relationship-based nature of direct lending and the bespoke nature of the loans involved means private credit investors who lack expertise can encounter a variety of risks. Inexperienced investors can face challenges in properly sourcing, underwriting, structuring and monitoring private credit investments. In addition, private credit investments often encounter illiquidity risk due to the extended investment horizon versus traditional stocks and bonds.

The rapid expansion of the private credit market in recent years has also given rise to increased regulatory scrutiny. This introduces the possibility of regulatory and legal risks in the years ahead.

Conclusion

In today's investing landscape, uncertainty abounds. Investors have little visibility on the road ahead for interest rates, market volatility, inflation and geopolitical risks.

Lending amid such uncertainty demands consideration of managing downside risk as well as balancing upside potential. With this in mind, it's more important than ever that private credit lenders possess an uncommon skill set: sector-specific expertise, strong sourcing relationships, structuring experience, and capital discipline. As Oaktree's co-founder Howard Marks has long said, "We can't predict, but we can prepare."



Endnotes

[1] Source: Preqin: Future of Alternatives 2029 (published September 2024); Preqin Global Report, Private Debt 2025 (published December 2024). There is no assurance that such events or projections will occur, and actual outcomes may be significantly different than those shown.

[2] "Middle-market companies" commonly refers to U.S. companies with $10-50 million in earnings before interest, taxes, depreciation and amortization (EBITDA).

[3] Preqin: Future of Alternatives 2029 (published September 2024).

[4] Source: Preqin, Bloomberg, Pitchbook LCD. As of September 30, 2024.

Key Terms

Capital Stack

Represents all the capital invested in a company. The capital stack provides a comprehensive view of the company's financial structure and sets out the order of priority for claims on its cash flows, which is vital for assessing risk and potential returns.

- **Common equity** is considered the top and riskiest layer of the capital stack. It carries the greatest risk because investment agreements entitle every other tranche of capital to be repaid before common equity holders. However, it is potentially the most rewarding layer since returns are not capped.
- **Preferred equity** is an equity investment that is superior in repayment priority to common equity but subordinate to debt. Technically, it is an equity security, but it shares many characteristics with debt instruments, such as offering reoccurring, fixed-income payments. However, this type of stock gives shareholders less voting power and has less earning potential.
- **Mezzanine debt**, positioned second to senior debt in the order of payment priority, plays a unique role in the capital stack. After all operating expenses and the senior debt payment have been made, any excess cash will be used to service the mezzanine debt. This type of debt typically offers a higher return rate than senior debt but lower than equity, making it an attractive option for certain investors.
- **Senior debt** has priority over all other positions in the capital stack. In other words, senior debt lenders must be paid before any other investor can receive a return on their investment. Investors who are risk-averse will likely want to invest in the lower portion of the stack, which has lower returns and lower risk. Those comfortable with higher risk levels and want a higher return will want to focus on the top of the capital stack.

Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA)

A measure of a company's core profitability. EBITDA takes net income and adds back interest, taxes, depreciation and amortization. It is helpful for comparing companies with differing levels of capital assets and related amortization/depreciation expenses.

Illiquidity Premium

The additional return investors expect as compensation for the cost and inconvenience of investing into assets that are not readily tradeable. The illiquidity premium is calculated by measuring the excess return of a less tradeable investment versus a comparable tradeable investment.

Liquidity refers to how easily an asset can be converted to cash. Illiquid assets (such as apartments) do not have a readily available market price and incur high transaction costs when buying or selling. As a result, investors demand a higher return for holding these types of investments.

Leveraged Buyout (LBO)

An acquisition of a portfolio company utilizing high levels of debt. Leverage levels can be as high as 90%, with the remainder funded by equity. In an LBO, assets of the portfolio company are often used as debt collateral to support the acquisition.

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Private Credit Risks

All investing involves risk. The value of an investment will fluctuate over time, and an investor may gain or lose money, or the entire investment. Past performance is no guarantee of future results.

As an asset class, private credit comprises 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.

Forward-Looking Statements

Information herein contains, includes or is based on forward-looking statements within the meaning of the federal securities laws, specifically Section 21E of the Securities Exchange Act of 1934, as amended, and Canadian securities laws. Forward-looking statements include all statements, other than statements of historical fact, that address future activities, events or developments, including, without limitation, business or investment strategy or measures to implement strategy, competitive strengths, goals, expansion and growth of our business, plans, prospects, and references to our future success. You can identify these statements by the fact that they do not relate strictly to historical or current facts. Words such as "anticipate," "estimate," "expect," "project," "intend," "plan," "believe" and other similar words are intended to identify these forward-looking statements. Forward-looking statements can be affected by inaccurate assumptions or by known or unknown risks and uncertainties. Many such factors will be important in determining our actual future results or outcomes. Consequently, no forward-looking statement can be guaranteed. Our actual results or outcomes may vary materially. Given these uncertainties, you should not place undue reliance on these forward-looking statements.

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Index Definitions

The Bloomberg Global Aggregate Index is a market-capitalization-weighted index comprising globally traded investment-grade bonds. The index includes government securities, mortgage-backed securities, asset-backed securities and corporate securities to simulate the universe of bonds in the market. The maturities of the bonds in the index are more than one year.

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.

The S&P UBS Leveraged Loan Index measures the market-value weighted performance of the investable universe of USD denominated leveraged loans issued from the following countries: Australia, Austria, Belgium, Bulgaria, Canada, Croatia, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Guernsey, Greece, Hungary, Iceland, Ireland, Isle of Man, Israel, Italy, Japan, Jersey, Latvia, Lithuania, Luxembourg, Malta, Netherlands, New Zealand, Norway, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, Sweden, Switzerland, the United Kingdom, or the United States.

The JPMorgan CLO 2.0 BBB Post-Crisis Index tracks floating-rate CLO BBB securities in post-crisis vintages, which consists of deals issued in 2010 and later. The index utilizes a market-value-weighted methodology.

The JPMorgan Corporate Emerging Market Bond High Yield Index (CEMBI HY) is a global, liquid corporate emerging markets index that tracks U.S.-denominated corporate bonds (high yield subset only) issued by emerging markets entities.

The ICE BofA Global High Yield Index tracks the performance of U.S. dollar-, Canadian dollar-, British pound- and euro-denominated below-investment-grade (IG) corporate debt publicly issued in the major domestic or eurobond markets.

The Morningstar Global Leveraged Loan Index is designed to measure the performance of the global leveraged loan market. It is a fixed-weight composite index consisting of 75% weight from the Morningstar LSTA US Leveraged Loan Index and 25% weight from the Morningstar European Leveraged Loan Index.

The S&P 500 Index is an equity index of 500 widely held, large-capitalization U.S. companies.

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