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ALTERNATIVES UNLOCKED
Unlocking Private Credit: A Different Kind of Lending

Credit is a fundamental component of the global economy. Ordinary consumers take out mortgages and auto loans, and companies often need to borrow to expand into new geographies, offer new products and services, or acquire another business. In return for their capital, lenders have the potential to earn steady income.

Private credit continues to grow and has cemented its place in the vast global credit system. It consists of loans privately originated and negotiated directly between a borrower and a lender or small group of lenders. In this guide, we'll cover the basics of this alternative asset class.

First Things First:
What is Private Credit?

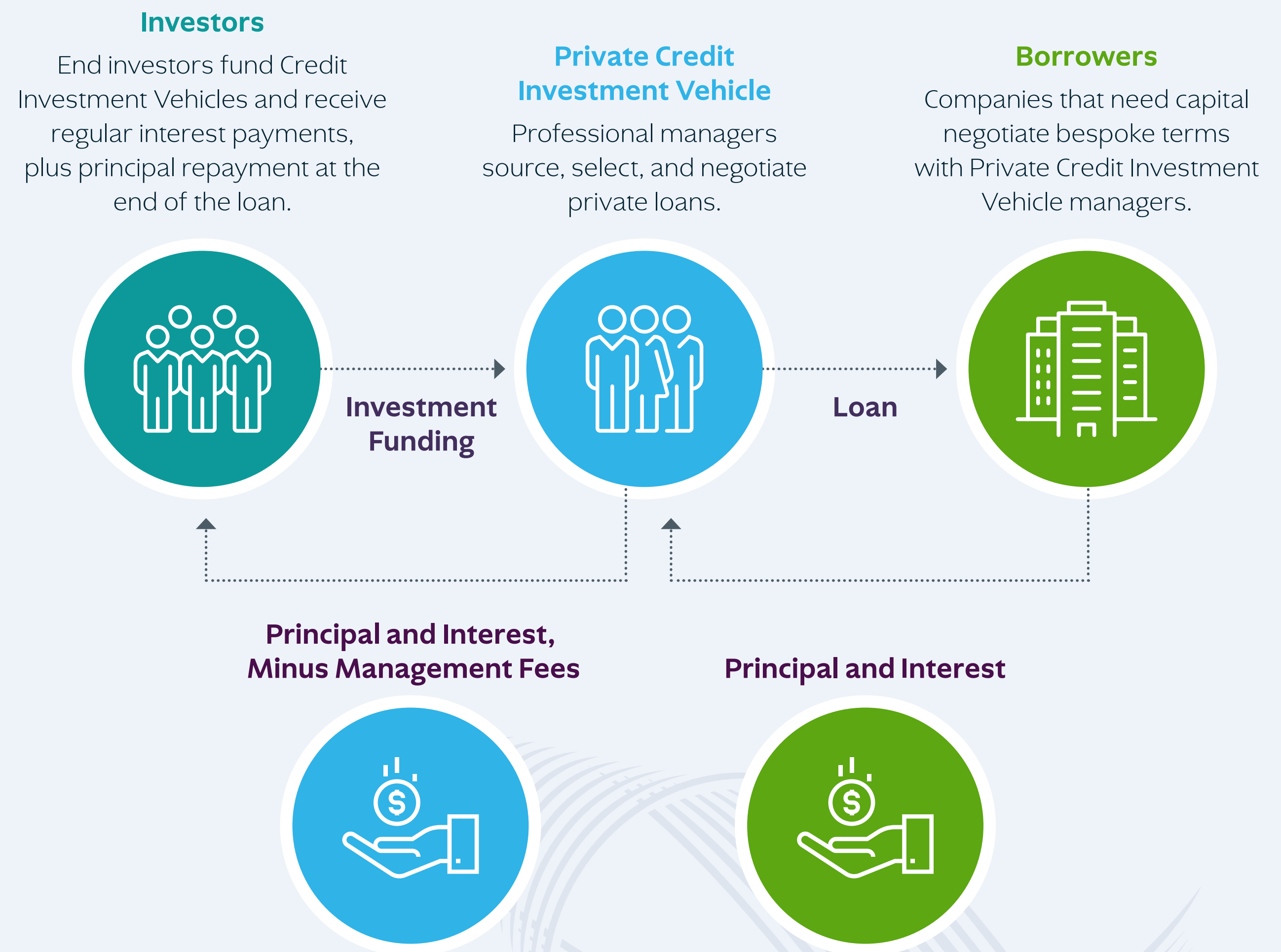
Risk and Return
in Credit Investing

Floating Interest Rates in the
Current Economic Environment

First Things First: What is Private Credit?

Private credit consists of loan agreements that are directly negotiated between the borrower and the lender. The loans do not trade publicly on any exchange or "over the counter platforms" between broker-dealers. Most of the time, when people say "private credit," they are referring to debt provided by non-bank lenders. Exhibit 1 shows how private credit often works in practice.

EXHIBIT 1 | Typical Private Credit Investment



Two Types of Private Credit Investments

Private credit includes a wide variety of sub-asset classes with different levels of risk, potential returns, and structures. We focus on two broad categories of private credit: **direct lending** to corporations and **asset-based finance (ABF).**

One important difference between these two is that corporations themselves take on direct loans and are responsible for repayment, but asset-based finance is secured by collateral that produces potential cash flows. If a borrower defaults, the lender is typically entitled to the collateral.

For direct lenders, the cash flows and overall financial health of a business is the most important factor to consider. In asset-based finance, a lender must first consider the quality of the collateral. The nature of that collateral can vary significantly (Exhibit 2).

EXHIBIT 2 | Different Types of ABF

Consumer/ Mortgage Finance

Asset types:
Pools of mortgages, credit card debt, auto loans, etc.

Hard Assets

Asset types:
Aircraft leasing, green energy, rail cars, home rentals

Commercial Finance

Asset types:
Equipment leases for small- and medium-sized businesses, accounts receivable payments

Contractual Cash Flows

Asset types:
Intellectual property, royalties (e.g. music rights), financial contracts

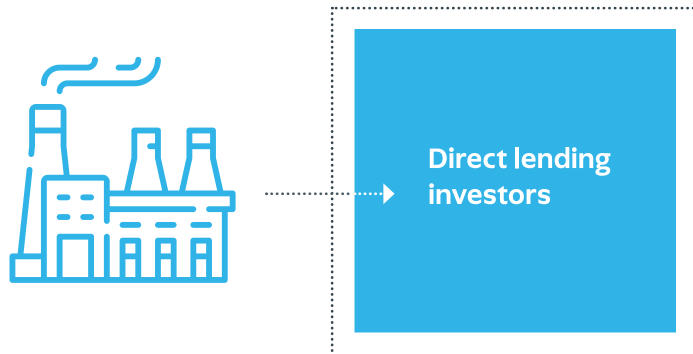
Term to Know: Asset Based Finance

Non-corporate lending backed by a wide variety of collateral, including tangible and financial assets owned by corporations and individuals. Exhibit 2 shows some of the different types of ABF.

Private Corporate Credit & ABF: Two Distinct Streams of Cash Flows

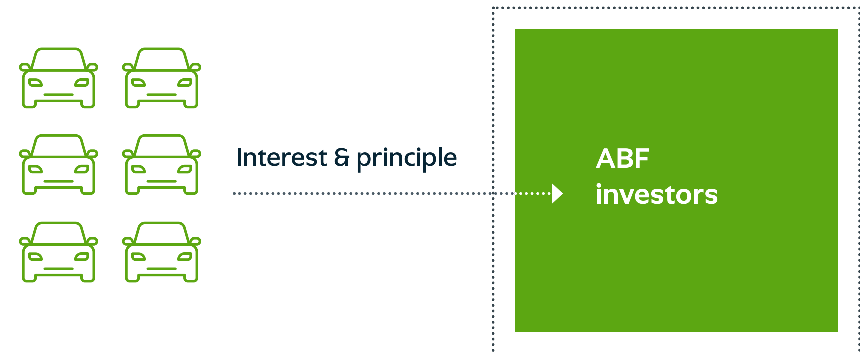
Corporate credit
(i.e., direct lending or cash-flow lending)

Typically, dependent on the performance and enterprise value of a single corporate borrower.



Private asset-based finance

Typically backed by a pool of hundreds (if not, thousands) of underlying loans, leases or other financial assets or hard assets, such as aircraft, railcars, or solar panels.

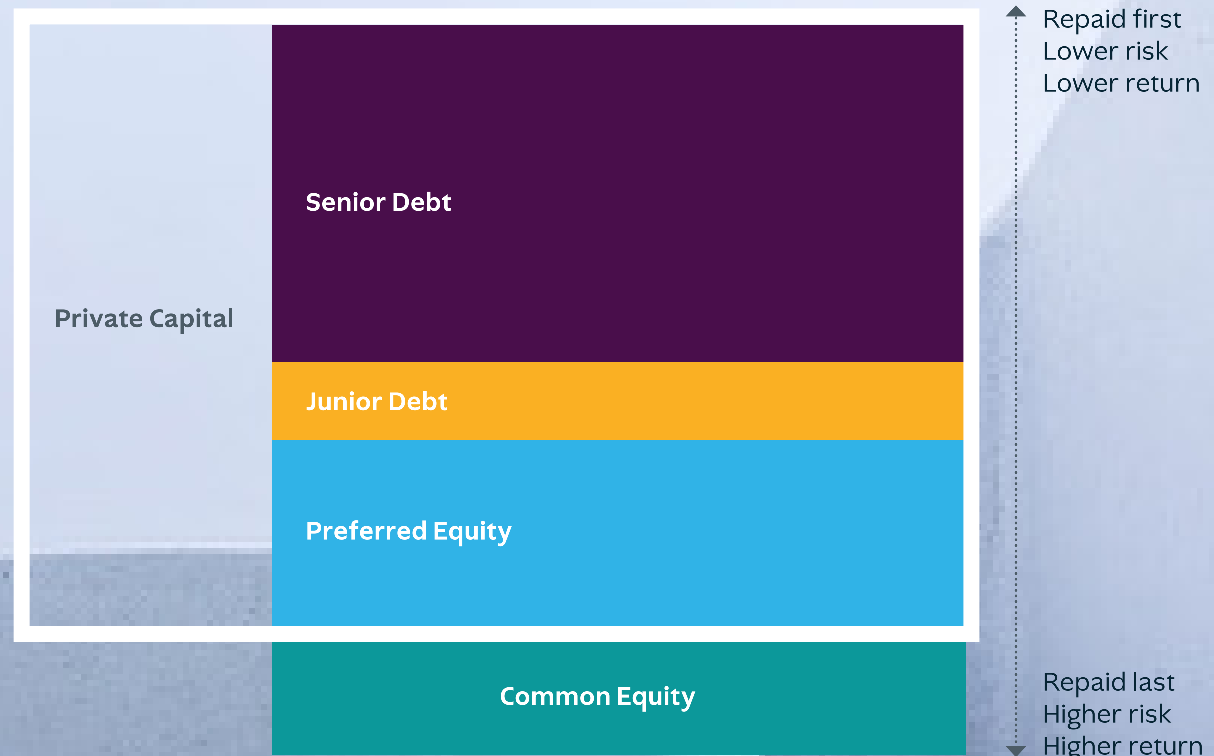


Risk and Return in Credit Investing

Seniority refers to the prioritization order in which investors are repaid in the event that a business or other borrower comes under stress. It is an important factor in weighing the risk and return of a credit investment.

Exhibit 3 shows a simplified example of the different kinds of capital that finance companies. Lenders are at the top, typically repaid ahead of equity shareholders, in order of seniority. Senior debt, as the name implies, must typically be repaid first and has the lowest risk and return potential. Equity owners sit below all debtholders and typically receive higher returns for taking on a higher amount of risk — they do not get paid anything until all debt holders have been paid first.

EXHIBIT 3 | **How Seniority Affects Risk and Return**



Source: KKR

Terms Are Key to Both Risk and Potential Returns in Private Credit

Private negotiations between borrowers and lenders allow for custom structures and protective terms for borrowers, lenders, or both (Exhibit 4).

EXHIBIT 4 | Terms that Can Protect Private Credit Investors

Protective covenants

Most private credit loans come with terms that borrowers have to meet or face serious consequences. These might include things like:

— Meet financial requirements (e.g., keeping debt within certain limits)

— Follow applicable laws and regulations

— Seek lenders' permission before engaging in mergers and acquisitions, change of control, or leadership shakeups

Collateral

If a borrower cannot pay back their loans, lenders may sometimes have the right to some of the borrower's assets in lieu of a cash payment. This type of debt is known as "secured" debt — that is it is secured over the assets of the borrower.

Word to Know: Covenant

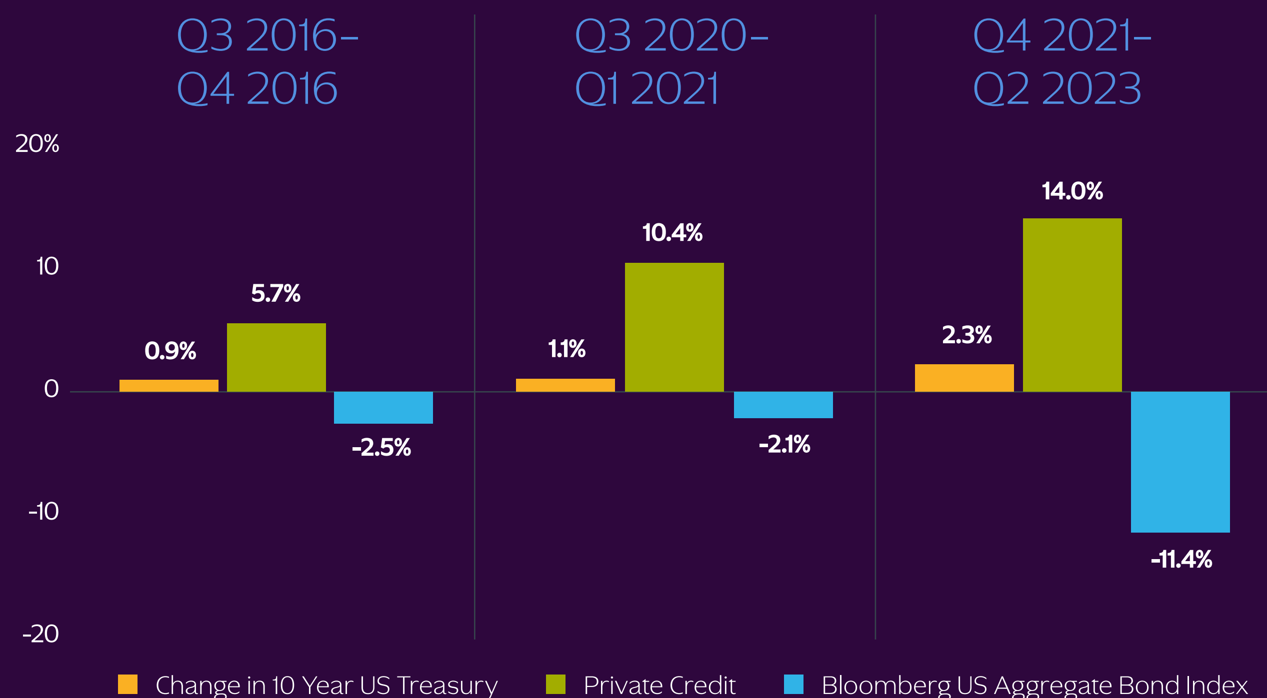
A condition that must be met by a borrower. A covenant is a form of contractual protection for a lender.

Floating Interest Rates in the Current Economic Environment

Inflation can be difficult for many asset classes because it sets the bar higher for the returns investors have to earn to achieve their goals, relative to "risk-free" U.S. Treasuries. If interest rates rise to combat inflation, existing fixed-rate debt may decline in value because new instruments issued at the newer, higher prevailing interest rates would provide higher returns. On the other hand, fixed-rate debt may be preferable when interest rates are declining.

Private credit investments typically have floating interest rates, which can help support returns when interest rates are rising (through base rate and margin of the loan), as Exhibit 5 shows, but may reduce potential returns when interest rates are falling. As central banks raise rates to try to fight inflation, the interest income from floating-rate credit investments also increases.. Conversely, if interest rates fall, the interest income tends to decrease.

EXHIBIT 5 | **Historical Credit Performance during Rising-Rate Periods**



Source: Bloomberg, Cliffwater as of 6/30/2023. Private Credit represented by the Cliffwater Direct Lending Index.

Learn More

To find out more about private credit investing, please contact your financial advisor.

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