TRO INVESTMENT GROUP

Private Credit — A Vital Asset Class for Today's Investors

PART 1

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Private credit has come to the fore in recent years, and we believe it has established itself as a vital investment option. We base our assessment on three key criteria:

1. **Private Credit's Multi-Faceted Investment Potential** Private credit is an important alternative asset class offering benefits critically needed in today's investment portfolios—superior yields, high risk-adjusted returns and low correlations to the public securities markets.

2. **Its Important Role in Commerce** As a source of finance capital, private credit plays a critical and growing role in the commerce and economy of the United States.

3. **Its Time-Tested Resilience** Private credit and the markets it serves have exhibited strong results through a considerable range of market environments.

In this Insights post, we'll focus on criteria number one. However, before we delve into private credit's investment performance, we want to acknowledge that many investors are not yet familiar with the asset class. So, we've included a brief overview on the next page.

THE BASICS

What is private credit?
The term private credit generally refers to direct loans made to business enterprises by lenders outside the traditional banking system, typically with the borrowing company's assets and cash flow serving as security for the loan.

In some ways, private credit is analogous to private equity. Of course, with a private equity investment, the investment firm or fund gains an ownership interest in the client company and generates returns by increasing the company's value. A private *credit* lender achieves returns through the receipt of loan interest payments and the sale or repayment of the loans.

Securing capital from a private credit fund (rather than through private equity) would typically be the preferred choice for business owners who don't want to dilute their ownership interest—as long as their business's financial condition can accommodate ongoing loan interest and principal payments.

Private credit direct loans are often "senior," which means they have top priority for getting paid back if the borrower runs into financial difficulty. But private credit loans can also be made at the *junior* or *mezzanine* levels. The lenders are often large sophisticated institutional investors with rigorous underwriting capabilities.

Specialty finance
While some in the industry consider *private credit* to refer to direct lending only, many others use the term to also include a broad array of niche debt investment opportunities often grouped under the banner of *specialty finance*.

A range of risk/return profiles
The different echelons of direct lending (senior, junior, mezzanine) and the wide range of specialty finance investments encompass a considerable spectrum of risk/reward characteristics. As you will see in this article, this diversity allows private credit to serve as more than just an income-generating alternative to bonds. **In fact, the private credit discipline also has the potential to produce equity-like returns—without equity-like risk.**

Criteria # 1: Private Credit's Multi-Faceted Investment Potential

It's a Key Alternative Asset for Investors, Offering Superior Yields, High Risk-Adjusted Returns and Low Correlations

Private credit investments offer a number of substantial advantages to investors who are comfortable with the asset class's typical lack of liquidity. (In many instances, investment capital may be tied up for 3 to 7 years or longer.)

Robust regular income / attractive yields

First and foremost, private credit offers exemplary income. According to Goldman Sachs, private credit has generated higher yields than most other asset classes over the past decade, including a 3%-to-6% higher yield than high-yield bonds. Over the past 18 years, private direct lending has produced income return averaging well over 10% per year.

AVERAGE ANNUAL YIELD

(2005-2022)

Source: Cliffwater Direct Lending Index (CDLI)

This superior yield stems from the fact that coupons on private senior loans are typically based on floating rates and have ranged from 7% to 12%, with the average around 10%. Rising interest rates have lifted today's yields, which are hovering around 12%.

The willingness of borrowers to pay a premium on private loans is a consequence of several factors:

- Mid-size companies are finding it increasingly difficult to obtain financing from banks or by issuing bonds.
- Even if a company could borrow from a bank, they would usually be able to attain a higher degree of loan customization from a private lender.
- Even if a company were in a position to pursue a bond issue, they would typically be able to achieve greater certainty and speed of execution via a private credit loan.

There are other important reasons behind private credit's favorable yields…

Income, yes. But it's not *fixed*

Traditional debt investments are known as "fixed income." When you own a conventional corporate bond, the coupon rate stays the same from the day you buy it until its maturity or sale. So, in a rising-rate market, the bond's coupon would not benefit from the rising rates. Furthermore, the bond's price would likely decline. Private credit investments are different.

Private credit loans are typically based on floating rates, which means that if interest rates rise, each loan's coupon automatically increases to reflect the change in the market rate. So, in a rising-rate environment, the yield of private loans can grow along with the market and the principal would remain unaffected.

But what if, rather than rise, interest rates were to fall very low? That could be problematic for a lender holding variable-rate debt. So, private credit sponsors often negotiate "floors" on their loans to insulate against steep declines in market interest rates.

Lower default rates and loss ratios than many public credit investments

One might naturally think higher risk would come as a tradeoff for private credit's higher yields. But this is simply not the case. In fact, private credit has historically experienced default rates and loss ratios that are considerably lower than those of high-yield bonds. (Whereas a default rate merely measures what percentage of loans default, the loss ratio reflects the actual amount of loss from each default—after it is adjusted for recovery due to collateral and/or workouts.)

LOSS RATIOS

(10 years ending December 31, 2022)

Private Credit Direct Lending	High-Yield Bonds
0.90%	1.47%

Sources: Cliffwater Direct Lending Index (CDLI);
Bloomberg US High Yield Bond Index

Why do private loans have lower losses?

We recognize that, in past years, low interest rates may have helped some private borrowers avoid defaults because they had been able to refinance their loans at increasingly lower rates. But there are several more-fundamental reasons why private credit loans exhibit lower default rates and loss ratios than other debt investments.

- The superior quality of private credit underwriting and due diligence relative to the public markets.
- The nature of the relationship between private lenders and their borrowers.
- Often, there is a private equity firm holding a stake in a private borrower's business.

We've included further insights into these points on the following page.

MORE ON PRIVATE CREDIT'S LOWER DEFAULT RATES AND LOSS RATIOS

Superior underwriting and due diligence relative to the public markets:

- **Greater specialization** Given the complexity of the private market—and its lower transparency—private credit investment sponsors tend to become experts in their areas of specialization in order to achieve success.
- **Closer lender/borrower relationships** Private lenders often build relationships with the companies they finance (sometimes sitting on their board), have greater access to the company records, and get to know their clients well.

Other protective factors inherent in the private lender/borrower relationship:

- **Negotiated safeguards** Private lenders can, and do, negotiate key risk-mitigation protections with their borrowers. For example: Although floating rates increase cash flow for lenders when market rates rise, a significant rise in interest rates can create stress for the companies they finance. Therefore, private lenders often require borrowers to acquire certain types of options that provide a hedge against rising interest rates.
- **Frequent private equity backing** Companies that borrow from private lenders are also often engaged with a private equity firm. When the company comes under financial stress, the private equity partner will typically be willing to extend help rather than risk deterioration of their ownership interest.

Even where default occurs, private lenders are generally able to encounter lower levels of loss than many of their public counterparts:

- **Collateral** In the case of senior loans, and with some other types of private credit finance as well, the lender has priority in claiming the borrower's assets serving as collateral. In comparison, high-yield bonds are subordinated to other creditors.
- **Workouts** With private credit financing, there is typically just a single lender involved. This eases the way for faster and more effective workouts when default occurs or is imminent.

Specialty finance: Potential for superior returns
Private credit funds have long evolved beyond direct lending and may also invest in another sub-asset class called *specialty finance*. Specialty finance encompasses a host of niche credit opportunities, such as the following:

These specialty finance investments exhibit a range of different risk/reward characteristics that skew towards higher return potential than that of direct lending.

TARGET GROSS IRRs

Private Credit Unlevered Senior Lending	Private Credit Levered Senior Lending	Private Credit Mezzanine Lending	Private Credit Specialty Finance
6% to 11%	11% to 15%	13% to 17%	7% to 20%+

Source: Cambridge Associates

As a result, the broad private credit discipline also offers the opportunity for equity-like returns in addition to favorable yields.

Hedge against inflation
It's worth mentioning that private credit investing features some inherent protection against the effects of inflation. First of all, the floating interest rates prevalent in private lending enable yields and principal to keep pace with increasing prices. Also, certain specialty finance strategies include collateral such as real estate, equipment and other "hard assets" that also serve as an inflation hedge.

An effective portfolio diversifier
While private credit investments may experience volatility, they are largely uncorrelated to the stock and bond markets. What's more, individual private credit strategies tend to be lowly correlated to each other. Many of the strategies are not particularly sensitive to broad economic cycles and some even tend to be counter-cyclical. Accordingly, private credit investments can serve well in diversifying a portfolio of stocks and bonds.

KEY TAKE-AWAYS: PRIVATE CREDIT INVESTMENT PERFORMANCE

In addition to playing an important role in the nation's commerce and economy, private credit is an important high-performance asset class for investors:

- Private credit/specialty finance produces superior income yields.
- It offers equity-like returns without equity-like risk.
- It helps protect against inflation.
- It's typically based on floating rates and performs very well in a rising interest rate environment.
- It is largely uncorrelated to the stock and bond markets and can serve as an effective portfolio diversifier.

Author's Viewpoint

At our firm, TRO Investment Group, we've been investing in private credit and specialty finance offerings for our fund portfolios since 2011. So clearly, we believe in the merits of this asset class.

However, I need to emphasize that investing in private credit is not without its challenges. First of all, there is wide dispersion in the performance of private credit funds. This alone suggests the importance of selecting the right fund sponsors. Accordingly, when evaluating sponsors, there are some key questions that must be considered:

- ✓ Is the sponsor an experienced professional in their area of specialization and have they achieved a successful track record?
- ✓ Does the sponsor have a strong network of industry relationships that enables them to source the most promising opportunities?
- ✓ Do they have the requisite skills in credit underwriting and loan negotiation to succeed in this complex, less-than-transparent asset class?
- ✓ Do they have the skills and resources to make critical adjustments in situations where a borrower becomes financially stressed?
- ✓ Does the sponsor invest alongside the investors in their fund?

Given all the compelling attributes of well-managed private credit investments, I encourage you to explore how you could diversify your own portfolio with private credit to enhance yield and return, as well as decorrelate from stocks and bonds.

In an upcoming Insights post, we'll delve into our second key criteria for favoring private credit—the critical role this asset class plays in our nation's commerce and economy. So, stay tuned.

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