Private Credit: An All-Weather Opportunity

Secular changes in the investment landscape and a global focus on risk-adjusted returns have highlighted private credit as an all-weather solution within the private markets universe.

More than ten years after the global financial crisis, private credit has become cemented among investors worldwide as a core alternative debt strategy. A decade of consistent, but subtrend, economic growth, stubbornly low interest rates, minimal inflation and unprecedented monetary accommodation have dramatically increased the popularity of private credit at the expense of traditional publicly-traded fixed income instruments.

The proliferation of private credit has its roots in the aftermath of the financial crisis. Increased economic and regulatory pressures discouraged many banks from traditional lending activities, particularly in the middle market, which is such a vital segment of the economy and where so many private equity sponsors are active. This void in credit creation has been filled in large part by alternative lenders such as private credit funds, insurance companies and non-regulated finance companies. This shift dovetailed with deep structural changes in the financial landscape, which led to a decline in initial public offering activity and larger numbers of mature, asset-light businesses seeking private capital.

At the same time, fixed-income investors have been faced with an environment of historically low real yields. Naturally, this has resulted in increasing allocations to credit alternatives that offered an attractive potential for higher risk-adjusted returns than those available in publicly-traded debt investments. In fact, annual returns for private debt –

Key Contacts

Dan Cohn-Sfetcu
Managing Director
dcohnsfetcu@portad.com
(203) 662-3028

Igor DaCosta
Managing Director
idacosta@portad.com
(203) 662-3042

Charles Harper
Managing Director
charper@portad.com
(203) 662-3041

John Kyles
Managing Director
jkyles@portad.com
(203) 662-8696

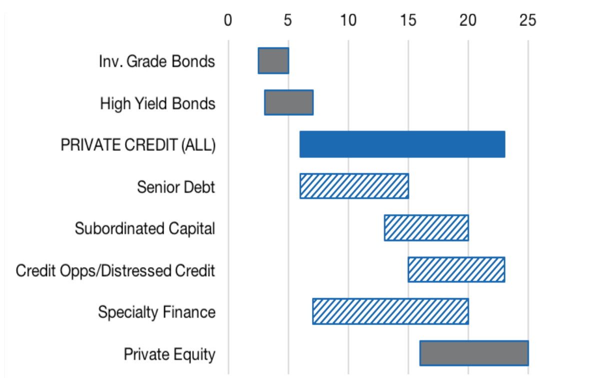
(continued on next page)

defined as senior direct lending, mezzanine (also known as junior debt), distressed, venture debt and special situations – have averaged around 10% since 2008[1], while exhibiting lower volatility when compared to public markets.

Accordingly, seven-year trailing fundraising for private debt has grown an average of 9% per year since 2013[2], while a record 420 private debt funds of all types were currently raising $185

Return Spectrum: Private Credit Vs. Others

Investment-Level Underwriting Targets (Gross IRR %)



Source: Cambridge Associates (see Endnote 13) . Returns for IG & HY bonds represent arithmetic return assumptions in equilibrium

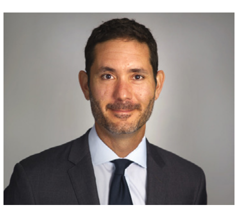
billion in capital as of June 2019[3]. Global private debt assets under management totaled a record $769 billion in committed capital as of June 2018, up from only $275 billion in 2009[4]. AUM in the segment is on track to surpass $1 trillion by 2020[5].

The longevity of the current economic expansion raises a number of key questions for private debt investors. Ten years into a growth cycle, is now the right time to be allocating to alternative debt strategies? If so, how will the asset class perform during the inevitable next down cycle, and how will those returns differ from the 2008-2009 period in both absolute and relative terms?

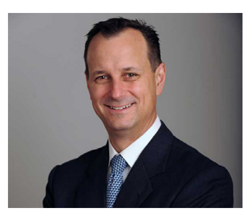
From Cyclical to Secular

Conventional wisdom holds that peaks in an economic cycle should coincide with either reduced exposure to debt in general or shifts in portfolio exposure toward distressed credits in anticipation of a recession (or both). While this approach may be prudent in theory, it is difficult to time economic cycles precisely – respected

Meet the Members of Our Private Credit Team



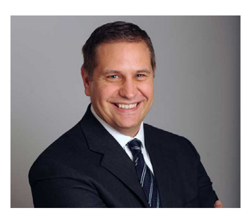
Dan Cohn-Sfectu
Managing Director
Senior Debt



Charles Harper
Managing Director
Mezzanine Debt

Igor DaCosta
Managing Director
Mezzanine Debt

John Kyles
Managing Director
Credit Strategies



Eric Staub
Managing Director
Mezzanine Debt

economists were predicting a U.S. downturn as early as 2012[6] – and to move quickly between different classes of debt.

Structured properly, private credit (particularly sponsor-backed senior and mezzanine debt) can offer a less cyclical approach. Private debt funds built with 3-4-year investment periods and 5-7-year fund lives typically assume some kind of cycle shift in their base case, and will often underwrite investments contemplating a downturn at some point during that timeframe. Strategies may include lending higher within a borrower's capital structure, or avoiding companies and sectors that might be vulnerable in a slowdown. Meanwhile, since private credit investments are generally illiquid, they may be better suited to managing through the ups and downs of a cycle than more liquid investments, which are subject to the vagaries and volatility of public markets.

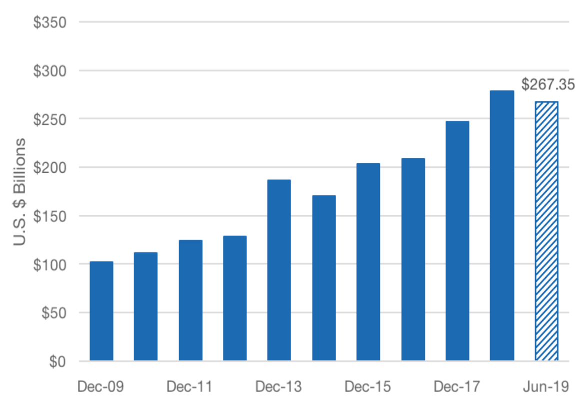
Furthermore, while the liquidity of public fixed income markets is often cited as an advantage over private credit, it may not be there when investors need it most. The financial crisis provided numerous examples of previously liquid corporate bond markets seizing up and going days without a bid as buyers evaporated. Since then, changes in regulatory requirements and risk tolerances have contributed to a dramatic reduction in the number of primary bond dealers engaged in secondary market-making activity, and by extension, the inventory of bonds they carry. These developments raise legitimate concerns about just how much liquidity would exist in any environment characterized by a need to buy and sell large blocks of bonds quickly[7]. Indeed, while the size of the U.S. investment grade corporate bond market grew 43% between 2007 and 2018, dealer inventories in 2018 were a mere 6% of what they were in 2007[8]. The reflexive belief that publicly-traded fixed-income securities naturally come with enough liquidity depth to handle periods of heightened market stress may be unfounded.

The inflow of capital into private debt funds over the past decade has resulted in a significant amount of money on the sidelines waiting to be invested. According to industry data provider Preqin, some $267 billion is committed to private debt fund managers and waiting to be deployed[9]. The accumulation of this "dry powder" may reflect the relative attractiveness of private credit's risk-adjusted returns in low-yield environments[10].

Increased capital devoted to private debt strategies is also indicative of an expanding opportunity set, particularly in the sub-$200 million (revenue) middle market, where most sponsored leveraged buyout transactions occur. Dry powder

Private Debt Dry Powder, US$ Billions

December 2009 - June 2019



Source: Preqin (see Endnote 10). Includes Direct Lending, Distressed, Mezzanine, Special Situation and Venture Debt totals.

on the sidelines is likely to enter opportunistically if the chance arrives, taking advantage of add-ons and acquisitions during a downturn even if the absolute number of new deals declines. In such an environment, funds that charge fees based on invested versus committed capital have an advantage, since their investors are only paying for what's actually put to work. This helps lower the pressure on a manager in the midst of a downturn, and reduces the risk of rushed or otherwise poor decisions.

Senior vs. Mezzanine

The boom in private credit has been dominated by direct lending funds, accounting for nearly 40% of the committed capital currently on the sidelines and 75% of the nearly $22 billion in new capital raised in the first quarter of 2019[11]. Meanwhile, only one relatively small distressed debt fund closed during the period, suggesting that concerns about a downturn have not yet translated into a widespread shift toward historically counter-cyclical private credit segments like distressed debt and special situations.

As noted, this is partially due to shifts in the cyclicality of credit investing, but another factor is a better understanding of the favorable risk/reward characteristics of first-lien and mezzanine debt. First lien debt sits at the top of the capital structure and is thus better protected in cases of default or a workout (although its upside is capped). Mezzanine, on the other hand, is lower in the capital structure, but often includes an equity component that can offer upside return potential beyond the debt's current yield and a cash yield component which can help mitigate J-curve effects. Importantly, in a world where many investors consider equities fully valued, mezzanine funds may generate better returns than stocks, and with lower volatility, because of this contractual yield.

Sponsor Success

In private credit, Portfolio Advisors concentrates on sponsor-backed deals. These transactions involve borrowers that are owned or controlled by private equity firms, and which are looking for debt financing for growth and/or M&A. In these cases, a private equity firm identifies an acquisition target and will commit, for example, 50% of the purchase price and lever that equity capital by borrowing the other half. Record private equity activity in recent years has generated a concurrent surge in demand for this kind of sponsor-backed senior and mezzanine finance[12].

Especially in the middle market, many investors believe the non-sponsored arena can generate higher yields. This makes sense, since the lender in a non-sponsored transaction shoulders significantly greater risk. By going directly to the borrower, a non-sponsored lender has to source deals internally, relying entirely on its own risk mitigation, due diligence, and monitoring competencies, and must be the backstop in case problems arise. With sponsored deals, on the other hand, a private equity firm's professional financial acumen may offer greater insights into the borrower both before and after closing, and the equity partner is the one acting as a backstop. When adjusted for risk, these factors can shift available yields in favor of the sponsored universe.

The PA platform works with middle-market private equity sponsors with meaningful capital behind them. Like us, they have a vested interest in seeing their assets perform through the cycle, and they structure transactions accordingly. Should problems arise, the likelihood of a private equity sponsor stepping in with additional equity is high; in a non-sponsored deal, where does that capital come from?

Another advantage to PA's focus on sponsored transactions is the alignment of interest between the lender and equity provider. We try to align closely with the equity sponsor on the timing of exits, the type and price of equity in a mezzanine deal. For us, this commitment to be completely in line with the sponsor plays to the strength of our platform and the deal flow we see. We're typically one of the largest players in the junior debt security of a given transaction, meaning we have a seat at the table when key decisions have to be made.

Why Portfolio Advisors?

- **25+ years private markets experience**
- **Diversified private markets platform**
- **Unique knowledge and relationships that enhance potential deal flow, information and selection**
- **Extensive database of financial sponsor performance and portfolio company history**
- **Focus on middle-market first-lien & mezzanine lending**

The insights available from our platform of relationships with private equity funds is a key differentiator for Portfolio Advisors. Through our network, built over more than two decades of private markets investing, we have an understanding of both private equity sponsors and their portfolio companies. This gets us to "speaking the same language" as the buyout fund manager, and provides current information about where capital can be deployed. Moreover, PA believes that same network of private equity fund relationships also generates high-quality deal flow, enhances access to information during due diligence, and improves ongoing portfolio monitoring – all advantages in terms of the underlying quality of borrowers and our ability to deploy capital quickly and prudently.

These core relationships also ensure close contact when problems arise. We believe it's much easier to work out issues, on both sides of the capital table, in a deal with one of our partners or a small group of "club" lenders than in a CLO syndicate with 30-40 participants. In practice, we believe the value of our platform is only enhanced in a downturn – in an era of loosening loan terms and fierce competition for deals, our network of long-standing relationships ensures that we're working on sponsored senior and mezzanine debt transactions with people and portfolio companies we know well and trust.

An All-Weather Opportunity

For thoughtful investors with an allocation to fixed income and considering the risk/reward of various credit alternatives, first lien and junior private debt exposure can offer competitive risk-adjusted returns and arguably greater resiliency in a downturn. Low correlation with publicly-traded credit, with less volatility, means an inherent ability to ride out cycle shifts and stay focused on longer-term outcomes. Meanwhile, private credit funds can be better suited to managing through economic cycles and can take opportunistic advantage of market dislocations. With a core focus on sponsored transactions, the Portfolio Advisors platform provides robust deal flow, helps with risk mitigation, and delivers compelling advantages in the rare instances when problems arise. Investors with fixed-income allocations should consider including senior and mezzanine debt transactions into their portfolios as an all-weather adjunct to other types of credit instruments. ■

Endnotes and Chart Citations

1) "Private Markets Come of Age," McKinsey Global Private Markets Overview, McKinsey & Co., February 2019, pg. 12.
2) "Private Markets Come of Age", McKinsey Global Private Markets Overview, McKinsey & Co., February 2019, pg. 12.
3) "Preqin Quarterly Update: Private Debt Q2 2019," Preqin Ltd., https://www.preqin.com/insights/quarterly-updates/preqin-quarterly-update-private-debt-q2-2019/26034, pg 5.
4) "The $770 Billion Private Debt Market is Ready for Consolidation," https://www.bloomberg.com/news/articles/2019-02-28/the-770-billion-private-debt-market-is-ready-for-consolidation, March 1, 2019.
5) "Private Credit Assets Projected to Top $1 Trillion by 2020," https://www.pionline.com/article/20181106/ONLINE/181109939/private-credit-assets-projected-to-top-1-trillion-by-2020, November 6, 2018
6) "A New Recession Seems Inevitable," https://money.cnn.com/2012/02/24/news/economy/double_dip_recession/index.htm, February 24, 2012
7) "Liquidity in Corporate Bond Markets Under Stressed Conditions", The Board of the International Organization of Securities Commissions, https://www.iosco.org/library/pubdocs/pdf/IOSCOPD634.pdf, June 2019, pgs. 10-12
8) "Is Bond Market Liquidity a Problem?", J.P. Morgan Asset Management, https://am.jpmorgan.com/us/en/asset-management/gim/adv/insights/is-bond-market-liquidity-a-problem, April 18, 2019
9) "Preqin Quarterly Update: Private Debt Q2 2019," Preqin Ltd., https://www.preqin.com/insights/quarterly-updates/preqin-quarterly-update-private-debt-q2-2019/26034
10) "Performance of Private Credit Funds: A First Look", Hu, Wendy et al, The Institute for Private Capital, May 7, 2018, pg. 12
11) "Preqin Quarterly Update: Private Debt Q1 2019," Preqin Ltd., https://www.preqin.com/insights/quarterly-updates/preqin-quarterly-update-private-debt-q1-2019/25830
12) "Private Markets Come of Age", McKinsey Global Private Markets Overview, McKinsey & Co., February 2019, pg. 13
13) "Private Credit Strategies: An Introduction", Cambridge Associates, https://www.cambridgeassociates.com/research/private-credit-strategies-introduction/, September 2017

PORTFOLIO ADVISORS LLC

Headquarters:
9 Old Kings Highway South
Darien, CT 06820
Phone: +1 (203) 662 3456

Zürich Office
Brandschenkestrasse 47
8002 Zurich
Switzerland
Phone: +41 (44) 200 3500

Hong Kong Office
33/F, Alexandra House
18 Chater Road
Central Hong Kong
Phone: +852 (3184) 9210

Headquartered in Darien, CT and founded in 1994, Portfolio Advisors, LLC is an independent, private markets investment specialist with more than $23 billion in assets under management. The firm also has offices in Switzerland and Hong Kong. Portfolio Advisors provides tailored private equity, private real estate and private credit investment solutions through commingled funds and custom advisory solutions via primary partnerships, secondary purchases, co-investments and direct senior and mezzanine investments. Portfolio Advisors has been an Investment Advisor registered with the U.S. Securities and Exchange Commission since 1994, and is also a Qualified Professional Asset Manager in the U.S.

Disclosure Statement

This material does not constitute an offer or solicitation for any fund sponsored by Portfolio Advisors, LLC (“Portfolio Advisors”) or its affiliates, or any investment services provided by Portfolio Advisors. No offer of investment services or sale will be made in any jurisdiction in which the offer, solicitation, or sale is not authorized or to any person to whom it is unlawful to make the offer, solicitation or sale.

This document includes information obtained from published and non-published sources that Portfolio Advisors believes are reliable. Such information has not been independently verified by Portfolio Advisors. Unless otherwise specified, all information is current at the time of issue. Any opinions expressed are those of Portfolio Advisors. The opinions expressed do not constitute investment advice and are subject to change without notice. Past performance is not a guarantee of future success and there can be no assurance that investors in funds will achieve the returns or investment objectives discussed herein. Investments in private funds involve significant risks, including the possible loss of the entire investment. The information herein is not intended to provide, and should not be relied upon for, accounting, legal or tax advice or investment recommendations. You should consult your tax, legal, accounting or other advisors about the matters discussed herein.

Distribution of this information to any person other than the person to whom this information was originally delivered and to such person’s advisors is unauthorized and any reproduction of these materials, in whole or in part, or the disclosure of any of the contents, without the prior consent of Portfolio Advisors, in each such instance is prohibited. Notwithstanding anything to the contrary herein, each recipient of this summary (and each employee, representative or agent of such recipient) may disclose to any and all persons, without limitation of any kind, the tax treatment and tax structure of (i) any fund described herein and (ii) any of its transactions, and all materials of any kind (including opinions or other tax analyses) relating to such tax treatment and tax structure.

Before deciding to invest in a fund, prospective investors should pay particular attention to the risk factors contained in the fund documents. Investors should have the financial ability and willingness to accept the risk characteristics of an investment in a fund. Certain information contained herein constitutes forward-looking statements, which can be identified by the use of terms such as “may”, “will”, “should”, “expect”, “anticipate”, “project”, “estimate”, “intend”, “continue”, or “believe” or other variations thereof. Due to various risks and uncertainties, including those discussed above, actual events or results or actual performance may differ materially from those reflected or contemplated in such forward-looking statements. As a result, investors should not rely on such forward-looking statements in making an investment decision.

Nothing set forth in this document is intended to constitute a recommendation that any person take or refrain from taking any course of action within the meaning of U.S. Department of Labor Regulation §2510.3-21(b)(1), including without limitation buying, selling or continuing to hold any security. No information contained herein should be regarded as a suggestion to engage in or refrain from any investment-related course of action as none of Portfolio Advisors, LLC or any of its affiliates is undertaking to provide investment advice, act as an adviser to any plan or entity subject to the Employee Retirement Income Security Act of 1974, as amended, individual retirement account or individual retirement annuity, or give advice in a fiduciary capacity with respect to the materials presented herein. You are advised to contact your own financial advisor or other fiduciary unrelated to Portfolio Advisors, LLC about whether any given course of action may be appropriate for your circumstances.