Private Credit and Your Portfolio

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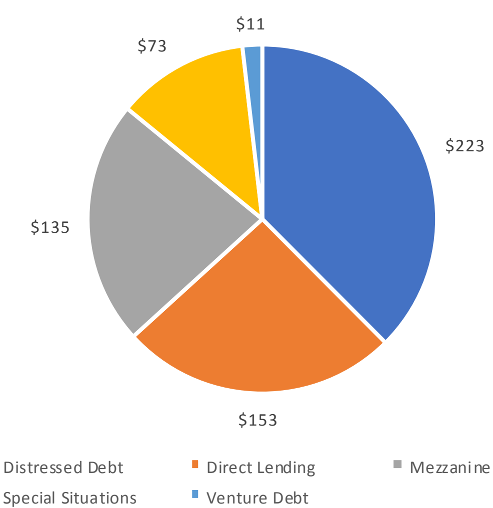
In the current low-interest rate environment, investors in search of yield may find the risk-adjusted return attributes of private credit quite compelling. Broadly defined, private credit includes strategies such as direct lending, distressed debt, mezzanine, venture debt and special situations. A diversified approach to these strategies can increase returns while lowering the risk of a traditional portfolio. An existing private equity portfolio can achieve further diversification by optimizing allocations with private credit.

The Private Credit Market

Private Equity Intelligence ("Preqin") estimates the size of the global market to be $595 billion, including $224 billion of dry powder. The composition of global assets by strategy is shown in Figure 1 below. In 2016, $93 billion of capital was raised by 131 private debt funds with the average fund hitting 107% of its fundraising target.

Figure 1. Global Private Equity Assets Under Management ($bn)



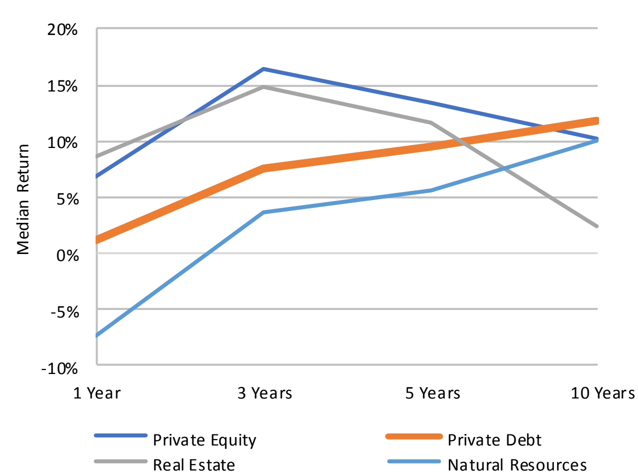
Source: Prequin Private Debt Online as of 10/31/17

Distressed debt has captured the largest share of the market at $223 billion, or 37%. Distressed debt managers acquire debt of companies trading at significant discounts to par, ultimately looking to obtain an equity stake through a reorganization process or to sell the debt at a higher price as the business rebounds. Direct lending, the next largest segment at 26%, exploits the funding gap for those companies that are considered too small or too high risk to receive a bank loan. Typically senior in the capital structure, these strategies tend to focus on smaller companies. Larger private companies over $50 million of earnings before interest taxes depreciation and amortization ("EBITDA") generally utilize syndicated loans and high yield bonds to raise debt capital. Mezzanine managers, at 23% of the private debt market, fill the layer between senior debt and equity by providing subordinated debt to companies. Special situations strategies are more opportunistic and may include mezzanine, asset finance, distressed debt, royalties and other esoteric strategies. Venture debt provides financing to venture backed companies as an alternative to dilutive equity financing.

The Portfolio Benefits of Private Credit

There is a wide range of returns within private credit which investors can utilize to achieve different risk-return objectives. The yields and relative spreads of private credit can be a complement to traditional fixed income strategies. Mezzanine is priced generally to yield 10% to 15% inclusive of fees and can provide additional upside via warrants or direct equity investments. Within direct lending, senior loans are priced typically at a floating rate spread to LIBOR, currently around 7% to 8% unlevered. However, several managers are utilizing leverage as part of their direct lending strategy which can provide a few hundred additional basis points of return but may also increase the strategy's risk. Venture debt is priced typically to yield a 9% to 12% coupon and includes warrants on the equity, while distressed debt is priced above mezzanine given its higher risk and potential for equity conversion. Figure 2 shows the overall returns of private credit relative to other private markets strategies.

Figure 2. Median Returns



Source: Prequin Online Products as of 10/31/17

Private credit returns are attractive within a broader private markets strategy and can provide diversification benefits. The asset class also provides the benefit of j-curve mitigation due to quarterly distributions of net cash yield from the underlying credits. In the absence of an existing private markets allocation, private credit is a good complement to traditional fixed income. As shown in Figure 3, private credit offers an attractive risk-return profile relative to high yield, which is the closest comparable asset class in terms of credit quality.

Private Credit remains attractive due to favorable demand factors and high satisfaction rates among current investors.

Figure 3. Private Debt/High Yield (2002-2016)

	Burgiss All Private Debt	Barclays Global High Yield
Mean Annualized Return	11.29%	10.61%
Standard Deviation	13.95%	18.06%
Mean Return / Standard Deviation	0.81x	0.59x

Correlations	Burgiss All Private Debt	Barclays Global High Yield
Burgiss All Private Debt	1.00	
Barclays Global High Yield	0.83	1.00

Source: Private-I Burgiss Index, Barclays Global High Yield Index, Bloomberg

Private Credit Investment Considerations

Per Preqin, the investment environment for private credit remains attractive due to favorable demand factors for future investments. According to a recent survey, 93% of investors in the asset class stated returns either met or exceeded their expectations in 2016 and 62% plan to increase their allocation going forward. Further, institutional investor presence remains relatively low at 37% versus 57% in the overall private equity market, 61% in real estate, and 40% in natural resources. The lower participation rate combined with high satisfaction rates may attract additional capital to the market.

However, the asset class is not without its challenges. Private credit fund managers surveyed by Preqin cited valuations, fundraising, and deal flow as the biggest headwinds over the next 12 months. Stretched valuations and competition from hedge funds have compressed returns in prior years, especially in the competitive sponsored market. Concerns about valuations and deal flow may portend a more competitive environment. These challenges amplify the importance of manager and strategy selection in light of the aforementioned demand dynamics. A focus on the lower-middle market and managers with low historical loss ratios may be an effective investment strategy. The inefficiency of the lower-middle market should continue to yield attractive deal flow at favorable valuations, particularly within senior lending, specialty finance, asset-backed finance, and royalties.

Conclusion

In closing, private credit's attractive risk-adjusted performance has the potential to enhance both a traditional portfolio and a private equity portfolio. Favorable demand dynamics may attract additional capital to the asset class which could stress valuations and deal flow. However, the lower-middle market tends to be more inefficient, and can be exploited to generate compelling returns. Investors that can successfully optimize their allocations and identify strong managers and strategies will be best positioned to benefit from the asset class.

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Mr. Brown earned his B.S. in Mathematics at the University of Texas, his M.B.A. at the University of Delaware and is a CFA charterholder.