CIO Office Insights

الجزيرة كابيتال
ALJAZIRA CAPITAL الجزيرة للأسواق المالية

Investing In Private Credit

June 2023

Key Insights

- Private credit has various types of investment strategies which can be split based on risk-return profile.
- Enables capital preservation and return maximization strategy through – direct lending, mezzanine debt, distressed debt, and special situation debt.
- Direct lending strategy accounts for 45% of the total AUM at $613 billion in private credit as of 2022[1].
- Private credit provides an attractive opportunity with default rates at 2.06% as on Q4 2022[2].
- As per Preqin survey, investor intention to increase private credit allocation rose by 16% in Nov-22.
- The average dispersion between the top and bottom quartile fund manager is~3.50% for the vintage period 2009-2019[1].
- This environment is well suited for fund managers focused on quality direct lending opportunities.

Elements of Private Credit

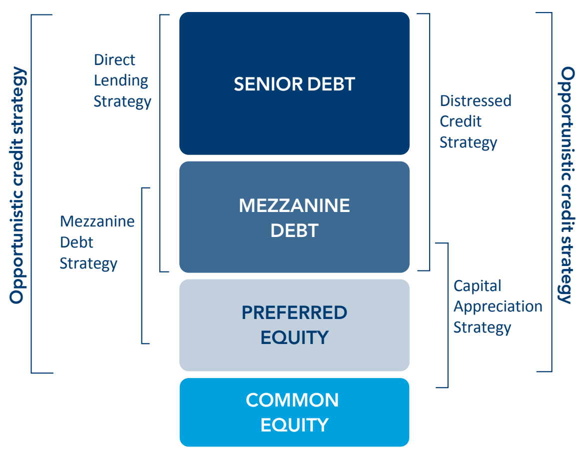
Private credit shares many similarities with traditional credit instruments (bank loans, bonds etc.), such as seniority, tenor, amortization, collateral provisions, and floating or fixed interest rate coupons. However, the dissimilarity between the two originates from private credit's ability to negotiate terms and conditions for each individual investment on behalf of both borrower and lender.

Private credit comprises of multiple investment strategies to assist an investor in diversifying their portfolio. The foundation for understanding all these strategies begins with understanding a typical capital structure.

Capital structure of a company refers to the particular combination of debt and equity, that is used to finance its operations and growth where equity lays down the foundation while debt provides the support to help the company grow.

Private Credit in a Capital Structure

Capital Preservation Strategies | **Return-Maximizing Strategies**



Illustrative Capital Structure

1. Preqin Global Report 2023
2. Proskauer's Q4 2022 Private Credit Default Index report focused on U.S. dollar denominated senior secured and unitranche loans.

Based on the capital structure, private credit's strategies can broadly be classified under two categories; capital preservation and return-maximizing strategies.

Capital Preservation

- This lending strategy is designed to cater mid-market companies with the primary objective to generate a steady return while preserving against any potential losses.
- The risk-return predictability is defined with "seniority" of the debt in the capital structure of the company.
- Direct Lending (first lien), Mezzanine credit.

Return Maximization

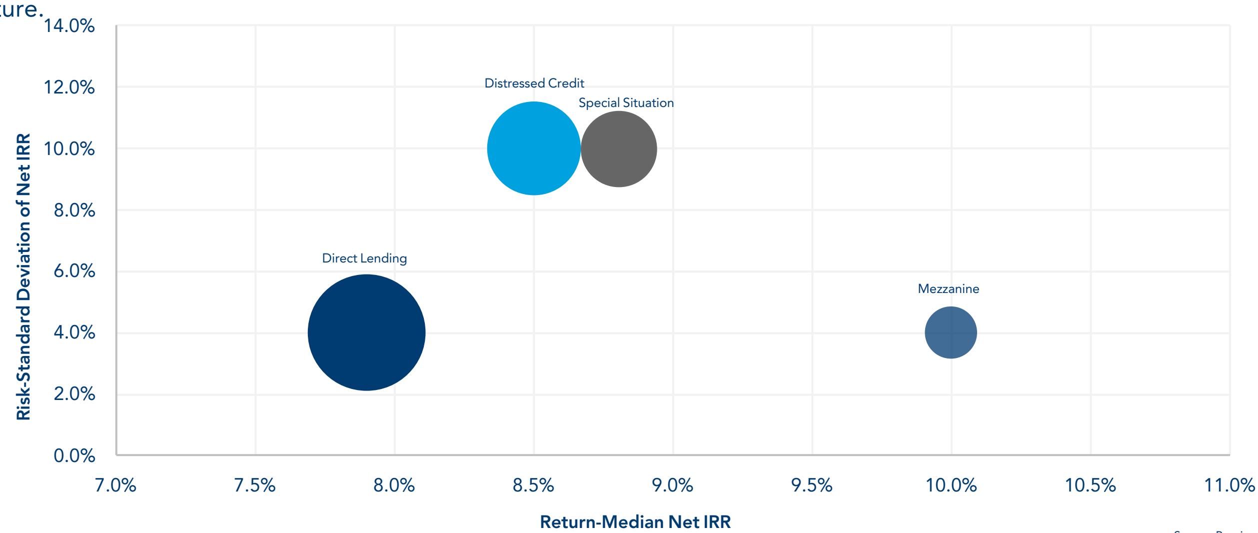
- Return maximization strategy focuses on providing loans to distressed companies with the objective of capturing private equity- like returns.
- However this leads to a less predictable return but offers a greater upside potential.
- Distressed credit and Special situation credit.

Within the compound of these categories there are various strategies which can be deployed as either an independent strategy or a combination of strategies to enable diversification and enhance risk-reward return.

Direct Lending	These loans are made directly to companies with seniority in the capital structure, collateral backing and floating rate coupons. Direct lending strategy represents 45% of the $613 billion total assets under management (AUM) in private credit as of 2022[1].
Mezzanine Credit	This is a junior capital investment in companies using a hybrid structure of equity and debt. This structure allows the investor to emphasize the capital preservation and a current-pay feature of a loan while also seeking additional upside through equity participation.
Distressed Credit	It is the process of investing capital in the existing debt of a financially distressed company. These investments are made by purchasing at steep discounts to the underlying value of the loan, with the purpose of assisting the company in restructuring and creating value.
Special Situation	This strategy is an opportunistic investment across the capital structure which may arise due to pricing dislocation caused by financial stress or an event-driven factor.

Private Credit Risk Spectrum

Each risk/return profile of the private credit strategies is dictated by the investment and their relative position within the capital structure.

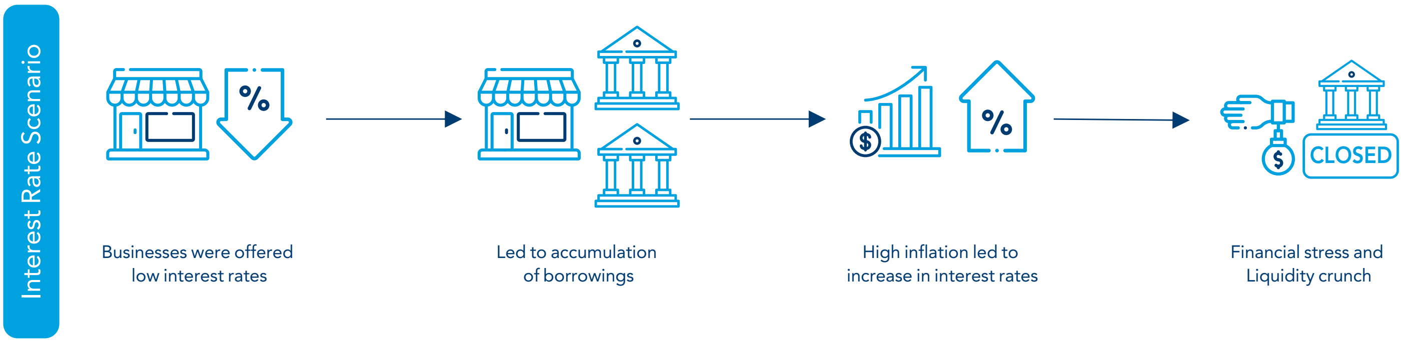


Source: Preqin

1. Preqin Global Report 2023

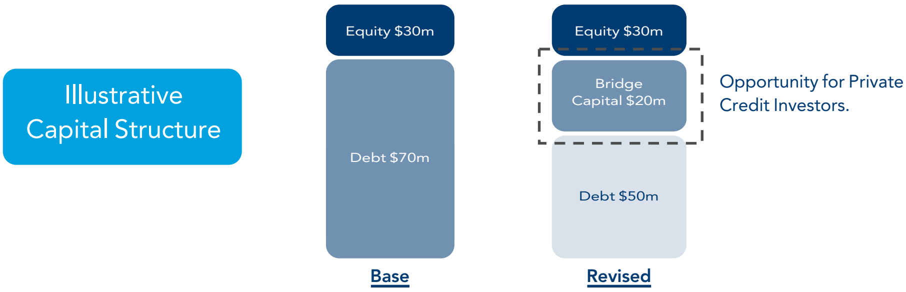
Opportunity within a Turmoil

In the last 15 years, global financial markets experienced low interest rates and supportive monetary policies. Accessible loans and low-cost credit became the norm. During this period equity risk premium maintained a high spread, making equity a more desirable investment. However, as a consequence of the pandemic and subsequent geopolitical turbulence, the global economic situation became vulnerable, resulting in high inflation pushing the US Federal Reserve to reverse its policies and leading to higher interest rates and limited market liquidity. Along with this, the traditional lenders became more conservative, demanding greater security for each dollar of debt.



Lets walk through an illustration; Company A, a mature cash-flow positive water bottling company, acquired a $100m machinery in 2020. The acquisition was supported by a $70m loan (70% loan-to-value) at a 3% interest rate, with the remaining $30m funded through equity. After 3 years, the loan is due, but in the current environment traditional banks only allows for a $50m loan (50% loan-to-value) at a 6% interest rate. This puts pressure on the company to either secure an additional $20m in bridge capital through further equity infusion or repay the entire loan amount.

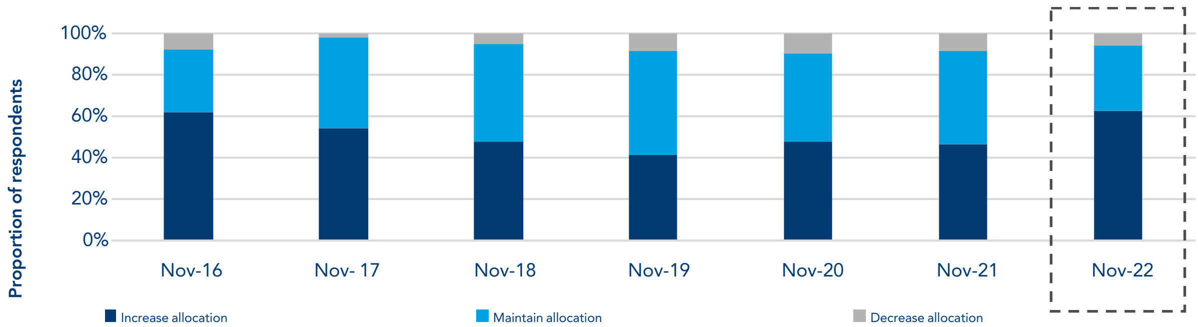
This capital structure gap presents an opportunity for private credit investors to achieve higher relative returns. As the gap has little to do with actual credit quality, investors can earn greater returns compared to the underlying risk.



This opportunity has dynamically shifted the image of the private credit asset class, it is now emerging as an essential item in investor portfolios with its capability of delivering cash yield of approx. 10%-12%(compared to 5%-6% in mid-2021)[1].

A recent Preqin survey on investors' private credit allocation intentions reveals an enthusiastic outlook for this asset class.

Investor Intent for Private Credit Allocation



Source: Preqin

1. Pitchbook Private credit 2023 (Leverage Loans) Outlook

How to Invest in Private Credit

Investors can access this asset class through a fund structure, such as a private credit funds.

Fund Type

These are investment pools that are actively managed by a fund manager. Established with a the purpose of investing in loans to private companies, with the aim of generating returns.

Strategy

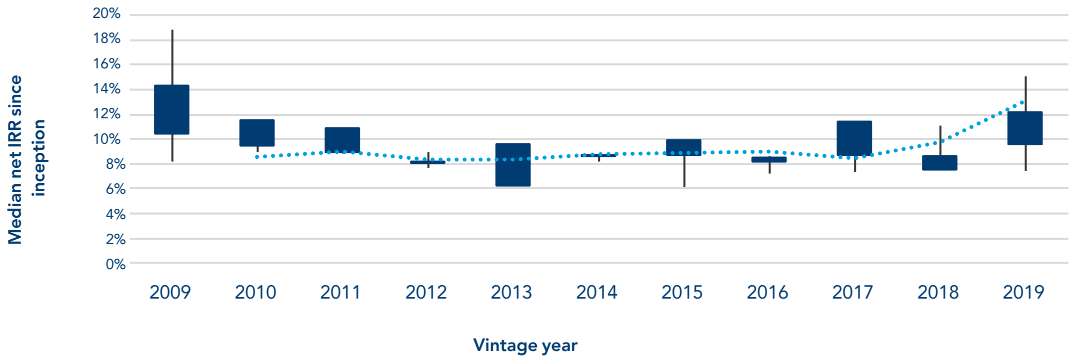
These funds can be specialized, with focused strategies such as direct lending with first lien and second lien, mezzanine debt, special situation (opportunistic) debt, and collateralized loan obligation, among many others.

Relative Performance

The dispersion of performance can be wide, even within a strategy, the range of outcomes can vary based on the skill and experience of the manager.

The difference between top-performing managers and the median has often been substantial, for the period 2009 – 2019, the average difference between a top and bottom quartile annualized return of fund manger in private credit fund was at 3.5%[1].

Private Credit Fund net IRR (%) by vintage year



Average 3.5% difference between top & bottom quartile annualized returns

Source: Preqin global report 2023 (Private credit median net IRR)

A successful private credit investing means identifying and backing fund managers with five key characteristics:

- A diligent credit selection process while ensuring true quality investment opportunity is identified;
- A track record across credit cycles portraying skill set of managing through stressed and distressed situations;
- A pipeline of opportunities which are large enough to support their fund size and prevail in the current environment;
- A robust governance and operational platform to ensure alignment of interest between the fund manager and investor;
- And the most critical is the ability to win deals of their choosing and on the terms of investors.

We believe that fund managers with these qualities, offer investors of all types and sizes, a safe and reliable way of investing in this asset class.

1. Preqin Global Report 2023

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