CIBC Asset Management

June 2021

PRIVATE CREDIT

OPPORTUNITIES TO IMPROVE RETURN AND DIVERSIFICATION

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Summary

- Private credit, also known as private debt, is a broad investment category of privately negotiated financing arrangements.
- Regulatory changes enforced on the banking industry following the 2008 global financial crisis reduced bank capacity to lend, particularly to Small and Medium Enterprises (SME), which don't traditionally access the public capital markets. Private lenders have stepped in to fill that void.
- Private credit investing requires deal sourcing, origination, structuring, and monitoring expertise.
- Private credit is characterized by lower liquidity than public market investments. In return, investors are typically offered higher levels of potential income from illiquidity and complexity premia, diversification from traditional asset classes (given the lower capital volatililty of private credit) and lower interest rate risk across the spectrum of private credit strategies.
- The breadth of offerings within this category provides investors with attractive replacement strategies for both public fixed income (capital-preservation objectives) and equity (return-seeking objectives).
- Allocations to private credit have grown in both institutional and high-net-worth investor portfolios, given depressed long-term return outlooks for traditional asset classes and the attractive qualities of private credit. We recommend that investors with a long-term focus and the ability to take on illiquidity risk consider private credit for their portfolios.

What is Private Credit?

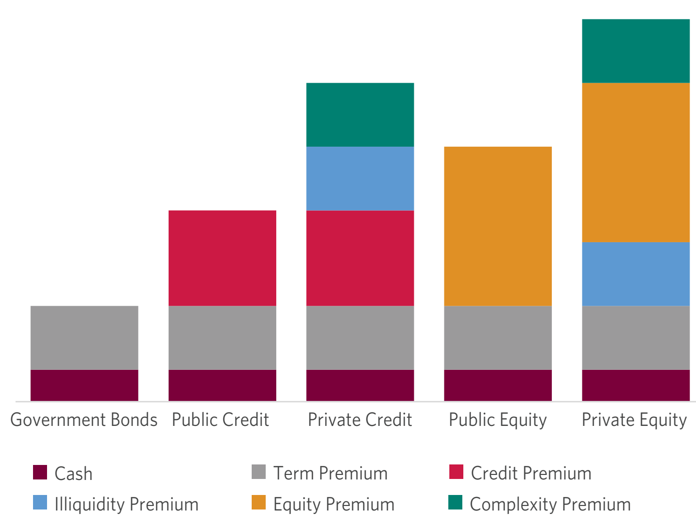
Private credit is a broad category with a diverse range of strategies—there are, however, several common defining characteristics. Lending is arranged directly between a lender and a company (sponsorless) or between a lender and a private equity firm acquiring a company (sponsored). The terms of the financing are privately negotiated between the lender and the borrower ("bilateral agreement") or a small group of lenders and the borrower ("club deal").

Borrowers are typically private companies or small- to medium-sized public companies seeking capital for acquisitions, buyouts, balance sheet recapitalization or organic growth.

Lending can be either cashflow based, where repayments are generated from the cashflow of the borrower's business, or asset based, where repayment is generated by a physical or financial asset like accounts receivable.

To compensate for limited liquidity, investors receive return premiums beyond the standard term and credit premiums offered by public bonds. Private investments offer limited public price discovery and secondary trading due to the private nature of the transaction. Each deal is customized to meet the unique needs of the borrowers while providing stronger covenant protection for investors compared to public market deal terms. Borrowers typically hold the investments until maturity or refinancing, so strong covenants are critical.

Figure 1 – Typical Components of Investment Return

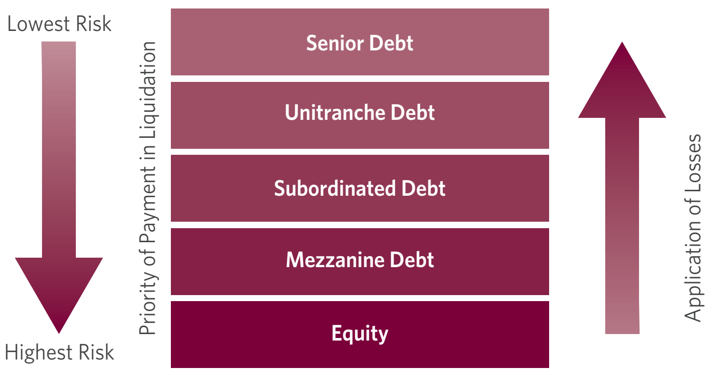


Source: CIBC Asset Management, For illustrative purposes only.

Private Credit Funds

Private credit strategies tend to focus on investments within a segment of the capital structure, although opportunistic strategies that move across the capital structure are also offered.

Figure 2 – Standard Capital Structure



Source: CIBC Asset Management, for illustrative purposes only.

Capital structure refers to the types of capital used to finance a business and the seniority ranking of each component of the structure in the event of default. The primary segments that private credit strategies invest in are outlined at the right.

Senior Debt

Senior debt receives priority claim in the event of default and is secured either by assets or cashflows.

Mezzanine (junior debt + equity)

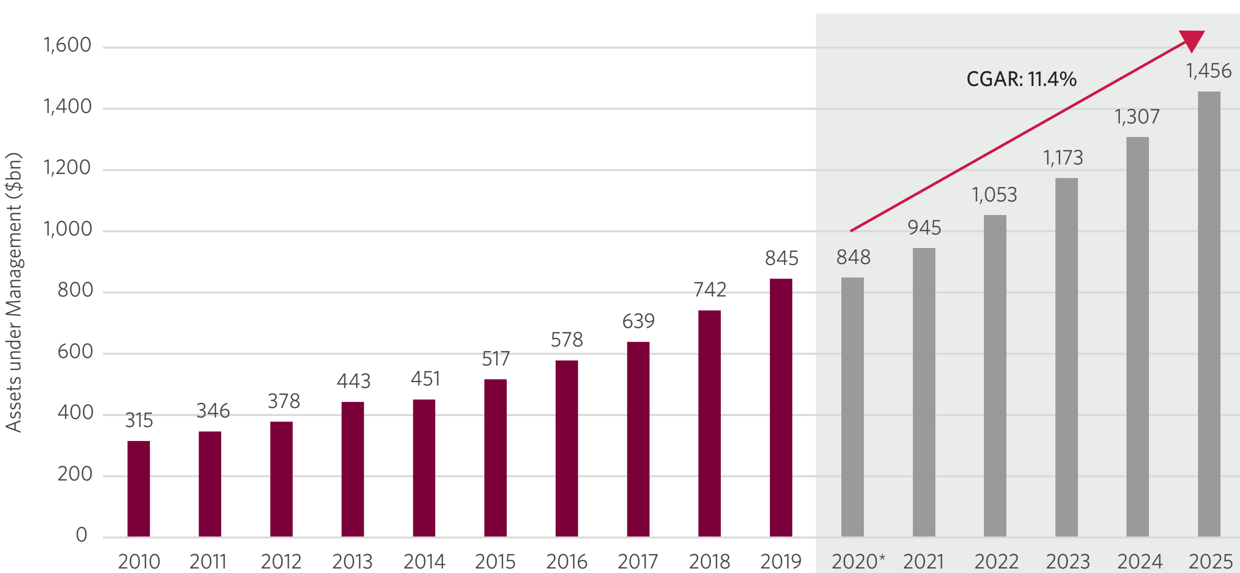
Mezzanine debt commonly refers to a hybrid of junior debt and equity and is typically combined with equity warrants. Mezzanine debt is the first class of debt to absorb losses in the event of default after equity capital is depleted.

Unitranche

Unitranche represents a single loan offering that combines senior and junior debt into one tranche. Sometimes managers market unitranche as senior debt, but it's important to remember it likely contains a mix of senior and junior debt.

Investment funds are often structured as closed-end investment vehicles, where there is a capital-raising period, followed by an investment period, and a capital-return phase. This structure is the most common because of the limited liquidity of the underlying investments. However, there are some funds that are offered as open-ended vehicles. These are typically in strategies with very short average loan maturities and/or funds that will hold a public securities sleeve. A public sleeve facilitates opportunity cost minimization for subscriptions (shortens the time it takes for an investor's capital to be invested) and promotes liquidity for redemptions, as public securities are more readily tradeable.

Figure 3 – Private credit assets globally



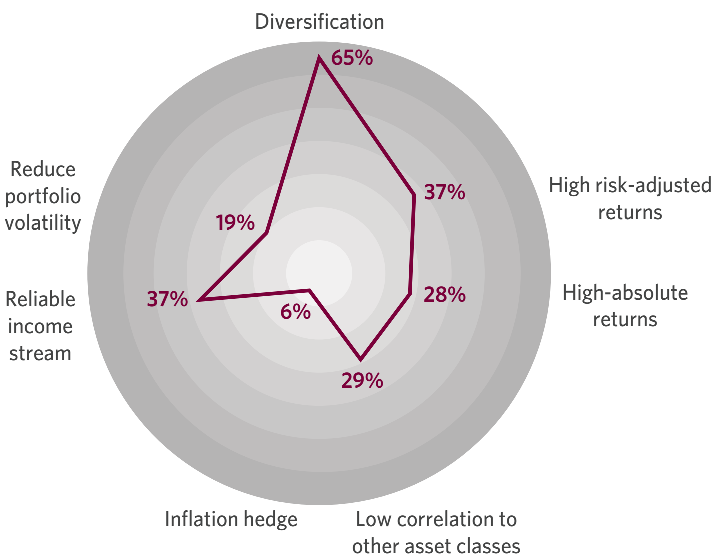
Source: Preqin November 2020, *2020 figure is annualized based on data to October. 2021-2025 are projections.

This asset class has grown considerably since the global financial crisis of 2008. Prior to this, banks were the traditional lenders in this space—they've pulled back from this market due to tighter regulatory capital rules. With private lenders stepping in to fill this void and an ultra-low yield environment, research[1] shows that flows into private credit are expected to see strong growth into 2025 and beyond.

Why Investors Want Exposure

Institutional investors have recognized for some time that private credit is an attractive asset class. Recent investor surveys indicate several key drivers behind increased allocations into private credit (see Figure 4).

Figure 4 – Why Investors Like Private Debt



Source: Preqin 2020 Private Debt Report, Preqin Investor Interviews, November 2019.

Diversification Benefits

Private credit strategies can exhibit low correlations to traditional asset classes, as they provide different sources of risk and return premia. Volatility also tends to be lower, although this is at least in part due to valuation techniques. Periodic appraised values are used rather than the continuous market-based values used for public investments.

Higher Income Potential

Private credit strategies take on varied levels of risk and target various levels of income. However, they all tend to offer higher income than traditional fixed income assets. This incentivizes investors to take on the unique risks and efforts associated with underwriting private transactions.

Capital Preservation

Privately negotiated terms between the lender and the borrower can provide stronger covenants than typical "cov-lite" deals seen in the leveraged loan and high-yield markets. A higher degree of direct communication between the borrower and the lender allows for faster and more customized dispute resolutions. Stringent monitoring requirements for borrowers provide early warning signs to lenders, while covenants provide direct recourse to influence the borrower's activities. All these dynamics help reduce the default rate or improve the recovery rate in the event of default.

Types of Private Credit

We've grouped private credit strategies into three main categories: capital preservation, return-seeking, and specialty finance. The lines between categories in private credit can blur, so it's important to consider these groupings as a general guidepost.

Capital-preservation strategies, such as direct lending (also known as mid-market lending) and mezzanine funds, focus on generating consistent, income-oriented returns while minimizing defaults.

Return-seeking strategies include distressed corporate credit funds and special situation funds that invest wherever they see an attractive opportunity across credit markets. These strategies provide higher potential financial upside, but also greater volatility and tend to be more cyclical.

Specialty finance tends to be characterized by niche offerings, are often asset- instead of cashflow-based, and focus on a particular market such as music royalties, aviation finance, or accounts receivable.

Direct Lending

Direct lending involves the origination and investment in senior, junior and unitranche loans made to small- and medium-sized companies. This segment of the market is also often referred to as mid-market lending. The proceeds are typically used to fund acquisitions, growth, recapitalizations or buyouts.

There are two main types of origination. The first is with private equity general partners (sponsored). The second type are loans made directly with the company (sponsorless). Spreads are higher for sponsorless deals because they require greater effort to source from a broad group of parties rather than a small cohort of private equity firms. These deals are also generally more complex. Returns for both types of transactions are generated through monthly or quarterly payments that are set using a floating reference rate plus a spread.

Direct lending funds are offered on both an unlevered and levered basis. Investors should assess the amount and frequency of leverage used when considering investment returns.

Mezzanine Funds

Mezzanine funds focus on subordinated capital investments in small- and medium-sized companies to fund acquisitions, growth, recapitalizations or buyouts. It's a hybrid asset class that sits between debt and equity in the capital structure and aims for returns that fall between senior private debt and private equity. Similar to direct lending, a large portion of the origination comes from private-equity-sponsored transactions.

Returns are primarily based on monthly or quarterly coupon payments composed of either a fixed or floating rate plus a spread. These funds also generate returns from prepayment penalties and payment-in-kind (PIK) interest. A PIK is an increase in the principal value owed to the lender rather than a cash interest payment by the borrower. This can help borrowers limit near-term debt servicing cash outflows.

Mezzanine funds often employ leverage and investors should evaluate the amount and frequency of leverage used when considering investment returns.

Distressed Debt

Distressed debt funds invest in debt securities of medium- to large-sized companies undergoing financial stress. There are a variety of strategies employed within this category, but the commonality is the purchase of securities at a steep discount in the open market or from existing creditors.

One principal strategy identifies sectors or securities that are temporarily dislocated but expected to benefit from an improvement in the financial situation of the company or industry. Another primary approach is to purchase securities of a restructuring company to gain equity control of the company post-bankruptcy.

Leverage is less common with distressed debt because of the high levels of credit risk embedded in the strategy.

Special Situations

This category focuses on medium- to large-sized companies in financial distress or experiencing idiosyncratic events. Situations can also include complex deals that few investors have the ability to analyze, underappreciated assets, or contrarian investing approaches.

These funds can invest in both privately negotiated transactions and in the public market and across the capital structure.

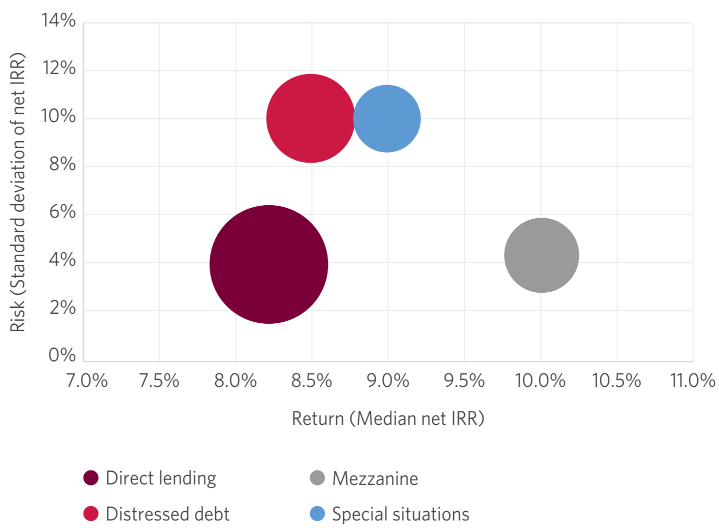
Special situation funds differ from distressed debt funds in that they have a much broader mandate in terms of the type of investments they pursue.

Specialty Finance

This category encompasses a wide variety of niche strategies including but not limited to working capital financing, bridge loans, aviation finance, pharmaceutical and music royalties, and litigation finance. Managers tend to focus on one industry and are experts in that space.

Lenders receive security against an over-collateralized pool of financial assets in lieu of traditional cashflow-based repayments. Over-collateralzation means the value of the collateral exceeds the value of the loan at the time the loan is originated.

Figure 5 – Private Credit: Risk & Return by Fund Type (Vintages 2011-2017)



Source: Preqin.

Direct lending and mezzanine offerings have produced higher returns than public high yield with similar volatility historically (return of 7.6% with a 9.2% standard deviation[2]). Distressed debt and special situation funds have aligned more closely with return-seeking public equity markets.

How to Allocate

There is no such thing as a "one size fits all" method when it comes to determining the appropriate allocations to asset classes. This is particularly true for private credit, where there are a variety of strategies to select from, each with unique features. Allocations to private credit can be asymmetrical—this means that, due to its relatively illiquid profile, it can be easier to rebalance a portfolio into this asset class than to switch out. This is why allocations should be made with a longer-term investment horizon.

Here are some guiding principles to consider:

- **Overall asset class allocation:** The higher the determined allocation to traditional fixed income, the higher the potential allocation to capital-preservation private credit strategies in place of some portion of public fixed income exposure. Similarly, a portion of equity risk can be substituted for return-seeking private credit.
- **Need for income:** The higher the income requirement, the more attractive private credit becomes.
- **Looking to replace equity or fixed income risk?** It's important to review the risk profile of a given strategy to determine if it's a capital-preserving or return-seekng strategy.
- **Liquidity needs:** The more predictable your cash needs and the lower your near- and medium-term liquidity requirements, the higher the potential allocation to illiquid markets.

With these guidelines in mind, consider the following allocations:

Conservative profile

Reallocate 5%-15% from core bonds in a fixed-income-heavy portfolio to capital-preservation-focused private credit.

For conservative investors, capital-preservation-focused strategies, direct lending in particular, provide a complementary allocation to core fixed income without material changes in total expected portfolio risk.

Income and Growth profile

Reallocate 5%-7.5% from core bonds to capital-preservation private credit and 5%-7.5% from core equities to return-seeking private credit.

For balanced portfolios, an allocation to both capital-preservation and return-seeking strategies can be appropriate. Allocations can be sourced from core fixed income and core equity, respectively. This can improve the expected return of the portfolio in a risk-conscious manner.

Growth profile

Reallocate 5%-15% from core equities in an equity-heavy portfolio to return-seeking focused private credit.

A growth portfolio focused on returns could consider trimming core equities in place of return-seeking private credit strategies.

Risks to Consider

While private credit offers investors more customized protections than public market bonds, there are important risks to consider.

Capital Risk

Private credit typically has an attractive credit risk profile due to the credit enhancements negotiated in each custom transaction. Loans are typically floating rate, which also minimizes the risk of rising rates.

However, loans are made to non-investment grade entities, so the risk of capital losses cannot be fully mitigated.

In addition, it's important to remember that the volatility profiles of private investment strategies are generally understated due to the customary valuation techniques of these investments. Public investments are continuously marked-to-market based on recent, readily observable transaction prices. Private investments are marked-to-market based on periodic evaluations conducted by external valuation agents and internal valuation committees. This process is less transparent and typically employs valuation techniques which result in more stable pricing over time compared to public market securities.

Illiquidity

Private credit investments don't involve an investment dealer and are made by either one lender or a small group of lenders. As a result, there are no readily tradeable market or public market prices to facilitate the fast liquidation of a position. These types of investments are typically meant to be held to maturity. As such, investors should consider their liquidity requirements and size their allocations accordingly.

The exception is private credit strategies that invest in public market investments such as distressed debt or special situation funds. To the extent that these funds invest in publicly-traded securities, there may be a greater degree of liquidity than privately-issued securities in direct lending or mezzanine funds. However, these strategies are still typically predicated on longer-term holding periods to allow time to work out through the distressed situations, so the liquidity offered by these funds can still be very limited.

Overall, private credit strategies will generally be less liquid than traditional public market fixed income alternatives.

Leverage

Leverage has the potential to enhance returns but can also magnify losses. Leverage also introduces funding risk, as the cost to fund the leverage varies over time. Leverage comes with terms that may favour the provider of capital, who can pull the leverage, potentially causing a fund to make a forced sale at an inopportune time. A forced sale can have a particularly negative impact with private credit given the relative illiquidity. Therefore, it's important to evaluate the returns offered by various private credit categories, both in terms of the frequency and extent to which leverage is employed.

Conclusion

Private credit is a broad category that includes options that can substitute for both debt (capital-preservation substitute) and equity (return-seeking substitute). To determine the suitability of these strategies and calibrate the size of the allocation, investors must consider their investments in a total portfolio context and determine what returns are sought, how much risk can be taken, how this risk is budgeted across asset classes, and what level of liquidity is required.

Strategies like direct lending and mezzanine funds typically aim for higher returns than public corporate credit with similar volatility. Distressed debt and opportunistic strategies aim for returns that are higher than public equities with similar volatility.

Against a backdrop of depressed interest rates and long-term return forecasts, private credit offers investors a potential source of higher yields, diversification, and capital preservation. Investors should strongly consider the merits of this asset class for inclusion in their portfolios.

Let's connect

Should you have any questions about this report or anything else, please don't hesitate to connect:

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[1] Preqin, November 2020

[2] BofA Merrill Lynch US High Yield Index Total Returns from 2004-2017

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