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# Private Credit: An All-Weather Asset Class

Demand for private credit has exploded over the last decade. We believe this market—now nearly $1.8 trillion in assets across an array of subsectors—will continue to present attractive opportunities for investors. In this paper, we explore the private-credit landscape and take a closer look at key pillars within it.

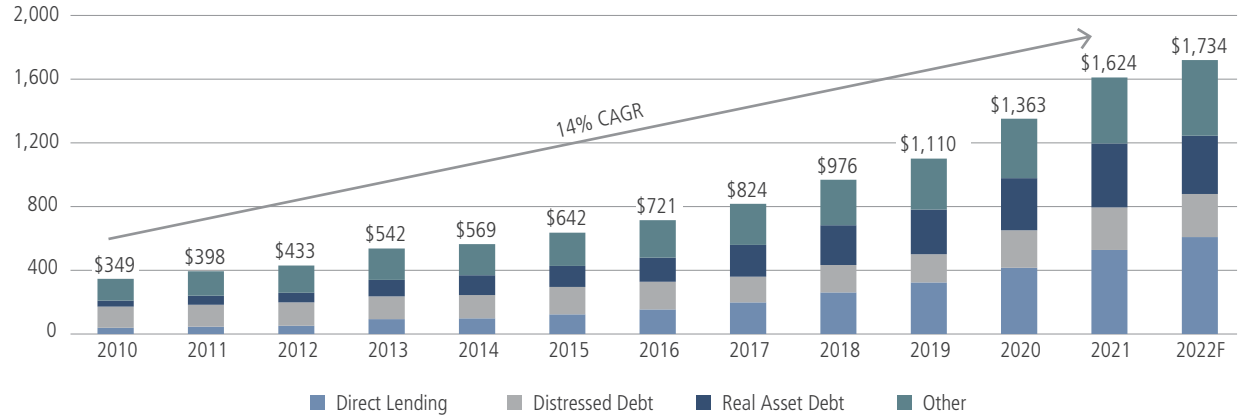
## There Is Finally "Income" in Fixed Income

When the 2008 Great Financial Crisis (GFC) struck, the U.S. Federal Reserve responded by nailing interest rates to the floor. Starved for yield, fixed-income investors gradually looked beyond publicly traded government securities and corporate bonds for relief.

Since then, the market for private debt has exploded in size, diversity and complexity. Between 2010 and 2022, assets under management grew at a 14% compounded annual rate, with the total—including commercial real estate and infrastructure debt—now approaching $1.8 trillion (see figure 1).

**FIGURE 1: INVESTORS HAVE FLOCKED TO THE PRIVATE DEBT MARKET**

Global private debt assets under management, inclusive of Real Estate and Infrastructure Debt ($bn)

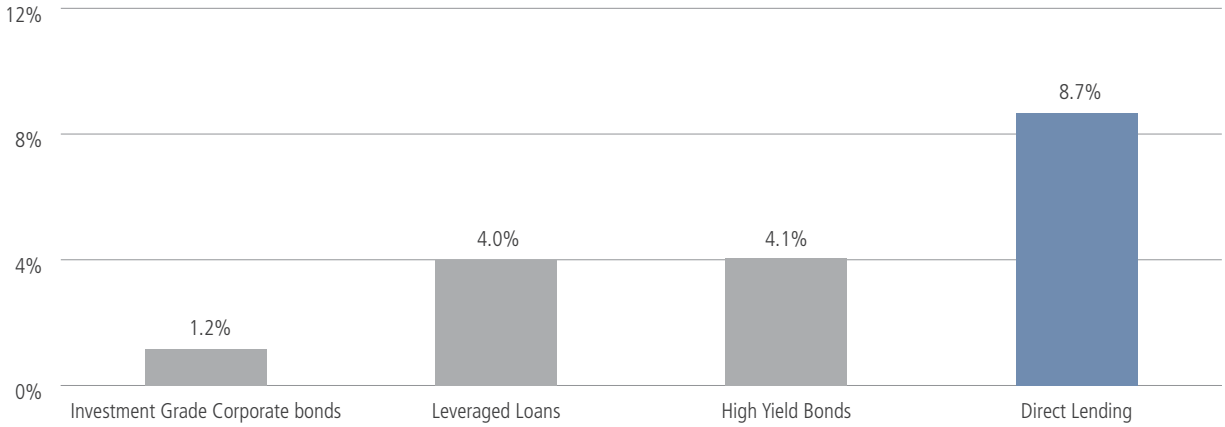



Source: Preqin, data through June 2022. Note: Real Asset Debt includes Real Estate and Infrastructure Debt.

Now comes a new economic regime: Central banks are no longer subsidizing rock-bottom rates and the cost of capital continues to rise in dramatic fashion. As private-credit providers can attest, there is finally "income" in fixed income! Over the last decade, direct lending's 8.7% annualized return has outshined other sectors across the credit landscape (see figure 2). That performance likely will draw even more attention: Preqin now projects that asset flows into private debt (excluding commercial real estate and infrastructure debt) will swell another 10.8% a year, to $2.25 trillion, through 2027.

**FIGURE 2: DIRECT LENDING HAS OUTPACED OTHER CREDIT SECTORS**

Ten-Year Total Annualized Returns on Select Credit Assets




Source: Bloomberg U.S. Investment Grade Aggregate Bond Index. Credit Suisse Leveraged Loan Index. ICE Boa HY Index. Cliffwater Direct Lending Index. Data as of March 1, 2023.

While we believe the outlook for private credit remains bright, in absolute terms and relative to other fixed-income subsectors, uncertainty remains elevated and economic headwinds persist, including inflationary pressure, higher interest rates for longer, and geopolitical turmoil. In our view, having a well-rounded private-credit portfolio with diversified exposures and return streams remains crucial.

As we continue to evaluate the market's vast and rich opportunity set, a few key themes have emerged:

1. **Quality bias:** As below-trend growth and higher rates threaten to expose cracks in weaker balance sheets, we believe providers of private credit should strive to stay high in the capital structure while focusing on quality companies in defensive sectors that have the potential to generate strong near-term cash flow. However, seeking reliable shelter doesn't necessarily require sacrificing yield: As discussed in greater detail below, we've found that all-in yield per unit of leverage has generally increased by 30% to 40% in the last year.
2. **Liquidity support:** Although market conditions eased in the beginning of 2023, liquidity is still relatively tight and central banks remain committed to keeping rates higher for longer. Lack of liquidity hasn't squeezed all sectors equally, but some have really felt the pinch. For example, plenty of private-equity-backed companies faced a funding gap in 2022 as capital markets shut down and banks were stuck with hung deals. Sensing opportunity, private providers of junior credit jumped into the gap, offering investors handsome yields at attractive terms (see our discussion of custom credit solutions below).
3. **Inflation protection:** As elevated prices threaten to apply further economic pressure, we believe asset-based lending has the potential to provide a partial hedge against inflation because the collateral backing the loans can also rise in value. In this paper, we will zoom in on two sectors of particular interest: residential real estate debt and asset-backed loans.
4. **Flexibility premium:** While whipping economic cross-currents could lead to greater dispersion within and across asset classes, we believe nimble investors can capture a "flexibility premium" by casting a wider net across income-producing subsectors and skillfully pivoting among them to maximize risk-adjusted returns. One approach, discussed later, is to adopt an opportunistic private credit strategy that seeks to achieve a particular outcome rather than a static commitment to a single sector or strategy.

## True Quality

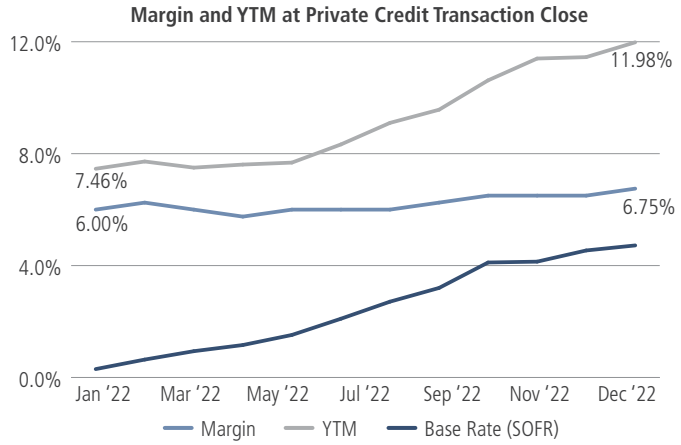
In typical direct-lending arrangements, investors make loans directly to mid-sized companies and, increasingly, to larger ones, too. These loans are often floating-rate, offering a potential hedge against inflation, as well as senior-secured—perched firmly atop the capital structure and well-guarded by covenants to help preserve capital.

As traditional lenders continue to retrench in the wake of macroeconomic uncertainty, we believe direct lenders can build resilient portfolios with stable cashflows by lending to high-quality companies at better risk-adjusted terms than available from broadly syndicated loans or high-yield bonds.

What does "high quality" mean? In our view, it generally implies that companies are demonstrating steady or improving revenue growth, as well as EBITDA margins in excess of 25%. In addition, we think investors should focus on companies with market-leading industry positions, exceptional management teams and reasonably forecastable business models in defensive industries, such as software, healthcare and business services. And as always, we believe that periodic stress-testing under a variety of economic and interest rate scenarios is clearly appropriate.

But focusing on quality doesn't necessarily demand settling for overly modest returns, in our view. In what we believe is a new economic regime marked by resurgent volatility, we find that high-quality companies have been willing to borrow at steeper rates to attract financing. Throughout the first quarter of 2023, the typical yield to maturity on direct-lending transactions (including original issue discounts, or OIDs) has been approximately 12.0% to 12.8%—that's SOFR + 625 – 700 bps, or 140 – 220 bps higher than the JPM public loan index (see figure 3).

**FIGURE 3: PRIVATE HAS ITS PRIVILEGES**




| Factors | Changes in New Underwritten Transaction |
|---|---|
| Reference Rate ▲ | 460 bps increase in reference rate between YE 2021 and YE 2022[1] |
| Spread ▲ | 75 – 100 bps increase in spread between YE 2021 and YE 2022 |
| OID ▲ | 50 – 100 bps increase in OID between YE 2021 and YE 2022 |
| Leverage ▼ | Down 0.1x between YE 2021 and YE 2022<br>Average of 5.4x |
| Enterprise Value ▼ | Down 1.2x between YE 2021 and YE 2022<br>Average of 13.0x |

Source: left chart: J.P. Morgan. YTM includes OID. Jan 2023; right chart: Lincoln as of February 2023. 1. As of December 31, 2021, 3-month LIBOR was 0.2%. As of December 31, 2022, 3-month LIBOR was 4.8%.

Access to high-quality companies may widen further as borrowers continue to deleverage in the current environment, thereby lowering loan-to-value ratios and potentially reducing risk for private lenders. For all of these reasons, we believe selectively managed private-credit portfolios should continue to play an important role in broader asset allocations.

## Helpful Hydration

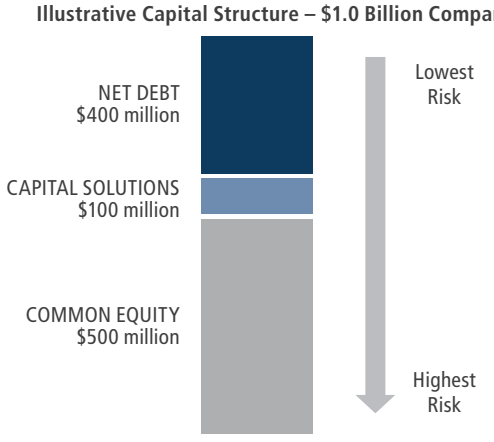
When liquidity dries up, attractive opportunities can emerge further down the capital stack—including highly customized capital solutions for larger companies held by premier private equity (PE) sponsors.

Unlike traditional private-debt deals that seek to generate healthy cash yields, these privately negotiated instruments—which tend to sit one turn behind senior debt but still ahead of the equity portion—have the potential to deliver attractive total returns on invested capital at relatively low levels of risk (see figure 4). Instead of quarterly cash coupons, investors often receive a contractual coupon paid-in-kind (easing the borrower's cash burden), along with an OID and additional call protection. In some cases, investors can enhance overall returns though equity participation in the form of warrants or co-investments.

**FIGURE 4: CUSTOM CREDIT ARRANGEMENTS CAN OFFER ATTRACTIVE YIELDS AND REASSURING SAFETY**

**Potential Benefits for Investors**

- **Attractive absolute returns** through investments in scaled, quality issuers
- **Contractual dividends** and minimum return on capital
- **Less valuation and duration risk** associated with common equity
- **Lower mark-to-market volatility** due to contractual nature of return
- **Upside through equity participation** and warrants
- **Private-equity-like returns** without the use of leverage




Source: Neuberger Berman.

To further illustrate, suppose a large PE sponsor borrowed at a low floating rate to buy a high-quality, fast-growing company. Assume, too, that the company will need access to additional capital to meet its strategic growth targets. Suddenly, rates spike and the market slumps, leaving the sponsor with little room to take on more cash-pay debt or raise incremental equity at a high-enough valuation, ultimately jeopardizing those long-term growth targets. Meanwhile, potential exits—in the form of a strategic sale or an IPO—have slammed shut.

In this increasingly common scenario, providers of custom capital solutions have been able to supply welcome liquidity at significantly favorable terms. In recent months, we have found that structured capital—even for premier assets held by blue-chip PE sponsors—can command contractual yields of 16 – 18%, with additional upside through warrants and other equity kickers.

This trend, we believe, is not slowing anytime soon. As the Fed hiked interest rates to stem inflation, sponsor issuance of high-yield bonds and leveraged loans fell 73% and 67%, respectively, between 2021 and 2022.[1] Now, many large direct lenders, who once were comfortable underwriting $1 billion unitranche loans, remain cautious about the impacts of a potential recession; at the same time, buyout activity has slowed as PE sponsors continue to face a dearth of available debt.

We believe these recent market dynamics will continue to create opportunities for thoughtful private capital providers—especially those with longstanding relationships with PE sponsors and disciplined underwriting processes. Furthermore, we think custom capital solutions can play a dependable role in broader portfolios by diversifying exposure to traditional direct lending, investing slightly lower in the capital structure, and potentially capturing equity-like returns with relatively lower risk.

## Collateral Support

### Residential Real Estate Debt

The $40 trillion+ market[2] for U.S. residential real estate is highly diverse, dynamic and always in need of financing. In light of recent market volatility and higher levels of inflation, we believe mortgage loans backed by U.S. residential real estate, and subject to disciplined underwriting criteria, can be an attractive complement to diversified fixed income portfolios.

Depending on the project, these loans run the gamut of durations—from short-term bridge loans to 30-year mortgages—and can provide array of potential benefits for investors:

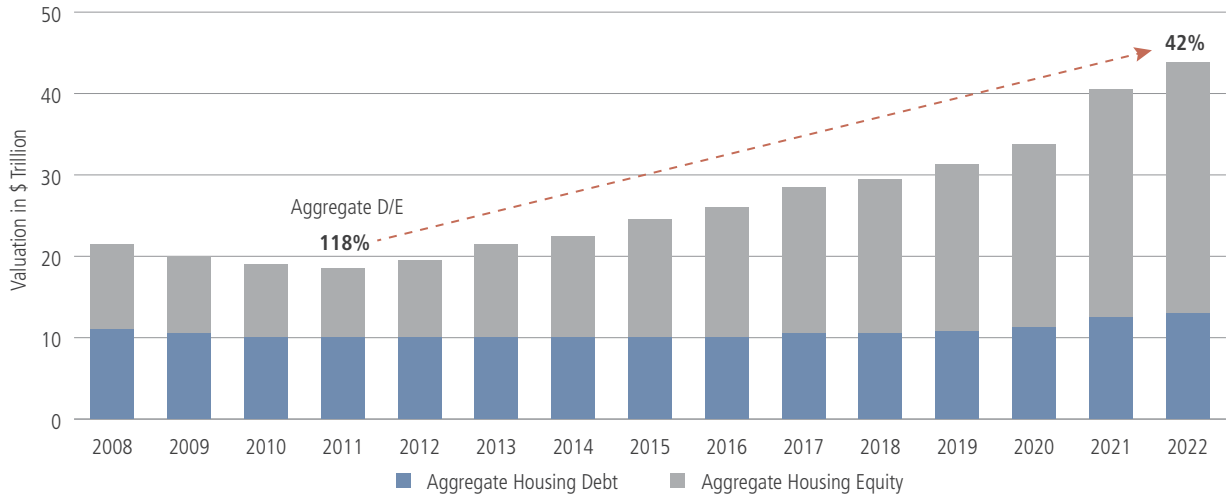
- **Inflation hedge.** Property values tend to rise with overall prices, which means that residential debt can provide an implicit inflation hedge and greater collateral coverage when inflation strikes. Loans with shorter durations, such as bridge loans, can offer additional protection by allowing investors to reinvest their returns at higher interest rates that often accompany inflationary periods.
- **Attractive yields.** Monthly interest payments can provide stable current income at relatively attractive yields. Current lending rates for the residential segment are in the 8 – 10% range, and with a modest application of leverage, we believe gross yields can rise to 12 – 14%.
- **High credit quality.** We believe there is a rich opportunity set of conservatively underwritten, first-lien, senior-secured assets further backed by well-capitalized sponsors.
- **Low volatility.** People always need shelter. That's why residential housing has historically proven less sensitive to the economic cycle as opposed to other real estate sectors and, in turn, corporate loans. And because the loans are senior-secured, they tend to be even less sensitive to fluctuations in the underlying assets. Appreciation in property values can provide additional equity cushion as well.
- **Diversification:** Typical loan portfolios often contain a large number of individual assets spread among various sponsors, loan types and geographies, thereby mitigating idiosyncratic risk.

In the years following the GFC, private-capital participation dwindled, along with the infrastructure—originators, warehouse banks and mortgage servicers—needed to facilitate it. Meanwhile, demand for safer credit has continued to grow: Thanks to rising home prices and stricter lending standards, homeowners have substantially deleveraged, creating more than **$22 trillion** in new home equity since 2011 (see figure 5).

[1] LCD, Refinitiv, Lincoln as of December 31, 2022.
[2] Urban Institute, *Housing Finance at a Glance, A Monthly Chartbook,* October 2022.

**FIGURE 5: THE GREAT DELEVERAGING LAID A FIRMER FOUNDATION FOR RESIDENTIAL REAL ESTATE DEBT**

No Net New Debt: Residential Housing Experienced Massive Deleveraging, With $22+ Trillion of Net Home Equity Created



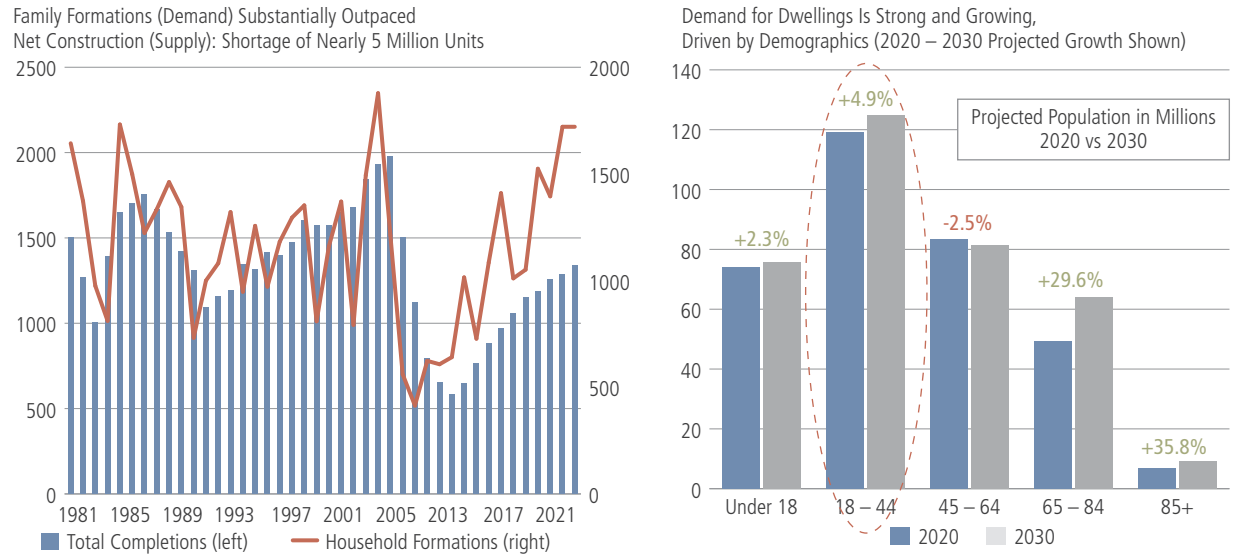

Source: Urban Institute, *Housing Finance at a Glance, A Monthly Chartbook,* October 2022.

For investors in residential real estate debt, we believe limited competition among private lenders and lower leverage among borrowers will likely continue to translate into attractive yields on safer loans.

While post-COVID home-price appreciation and higher mortgage rates may create headwinds in certain markets, we think a clear focus on geographic targeting, conservative underwriting and quality sponsors can serve investors well. We also believe favorable supply-demand dynamics should continue to support housing prices over the long term.

On the supply side, home inventories remain well below historic averages and severe housing shortages persist across many geographic areas, thanks in part to underbuilding after the GFC (see figure 6); also, distressed inventories, which are historically driven by mortgage delinquencies, appear unlikely to turbocharge supply given that most outstanding mortgages are fixed and thus unaffected by rising rates. As for demand, we believe millennials (who are in their prime home-buying age) will continue to drive it: Between 2020 and 2030, the population segment between ages 18 and 44—the country's largest—is expected to increase by 4.9% (see figure 6).

**FIGURE 6: DEMAND FOR HOMES PERSISTS, AND MILLENNIALS ARE PRIMED TO DRIVE IT**




Source: Morgan Stanley; household formation data through year-end 2021.

Given the sheer size and significance of the U.S. housing market, one could argue that many investment portfolios are underexposed to residential credit. In our view, gaining exposure to this asset class, maintaining underwriting criteria and monitoring ongoing performance present a host of executional challenges. However, we also believe that investors with specialized expertise, an established investment platform and access to dependable loan-origination channels are well positioned to generate stable, attractive returns in the current market and over the long term.

**Asset-Based Lending**

The investment thesis of a traditional corporate bond is typically based on a company's potential cash flow and enterprise value. By contrast, asset-based loans (ABLs) are primarily backed by an array of collateral—from accounts receivable and small business loans, to inventories and equipment. All else equal, liquid collateral (such as investment securities) can be safer than physical assets that aren't as readily converted to cash in the event of default. Like the sticks and bricks underpinning residential mortgages, the collateral supporting ABLs can offer stable returns, as well as a built-in hedge against inflation.

We believe compressed equity valuations and continued economic uncertainty continue to bode well for this asset class. Under rosier market conditions, companies looking to expand their operations or fortify their balance sheets might seek to raise additional equity to meet those strategic goals. Instead, we continue to see opportunities for investors to provide mature, stable companies with attractively-priced credit backed by assets sitting on their balance sheets, rather than in bankruptcy-remote vehicles (as has often been the case). These balance-sheet loans can offer first-lien interest in **all** of a company's assets, not just the ones it chose to cordon off. In the current market environment, selective investors are finding they don't have to trade away yield to gain this extra asset coverage, potentially increasing their risk-adjusted returns.

Here is a typical example: Assume a well-capitalized consumer-finance company with a 20-year track record wants to borrow $75 million to fund its growth plans. The company could arrange a first-lien ABL supported by the cash and unsecured customer loans on its balance sheet, with key covenants that require it to maintain a minimum 1.5 asset-coverage ratio and at least $15 million of liquidity.

Two years ago, that sort of transaction might have generated an all-in yield in the mid to high single digits. In the current environment, however, we have found that some borrowers have been willing to accept rates in the mid-teens, while throwing in additional protection such as restrictions on equity distributions or further borrowing. ABL deals are typically measured in terms of a loan-to-value (LTV) ratio, meaning the size of the loan relative to the value of the collateral supporting it. In an inflationary market, rising collateral values effectively lower the LTV, potentially reducing lenders' risk.

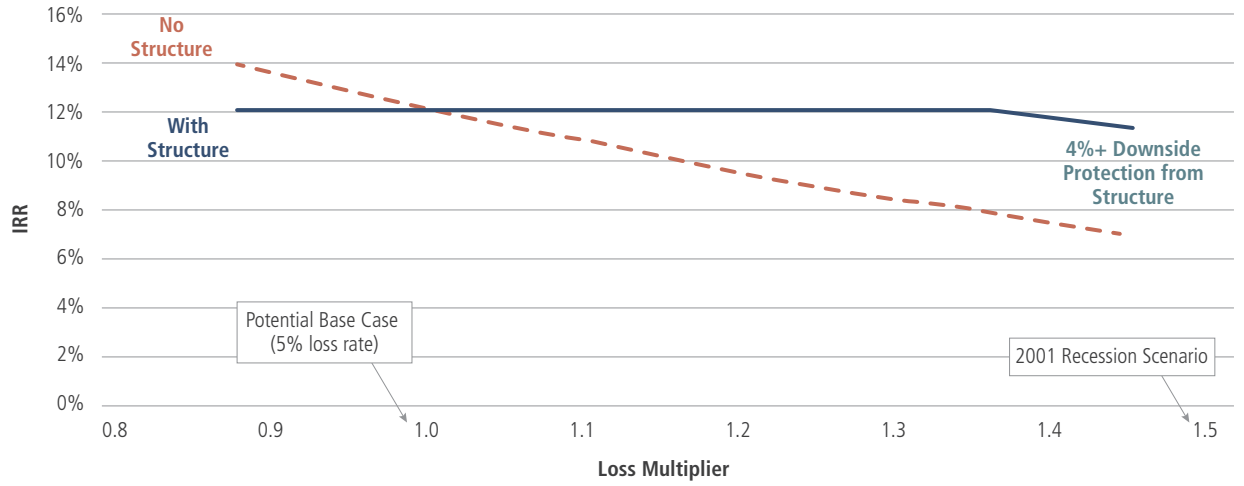
While this relationship may hold during the initial stages of an inflationary cycle, we believe what goes up tends to come down. If collateral values drop as inflation declines, borrowers might have to support their loans with additional collateral—or risk default. Therefore, we think it is crucial for lenders to conduct periodic LTV tests and to take a conservative approach when valuing collateral, which includes factoring in asset depreciation along the way.

Tracking LTV on an ongoing basis can be challenging in more opaque and volatile markets. That's why we also think investors should seek to lend against shorter-duration collateral, such as inventories that turn every 30, 60 or 90 days, thereby allowing assets to be re-marked at their current market value and offering a more meaningful LTV measurement. High-turnover collateral can also be quickly deployed to pay off the ABL, potentially avoiding a distressed-asset sale if refinancing isn't available when the loan comes due.

Structuring is another critical aspect of investing across ABL sectors. If designed meticulously, structuring can improve risk-adjusted performance by protecting against large potential losses (see figure 7). As shown in the chart, a typical ABL with structure can reduce risk sensitivity—measured as a multiple of base-case losses—while only giving up marginal upside. Structuring can take many forms: It might include a contractual obligation to post additional collateral, such as inventory or unencumbered cash, or it could involve a hybrid arrangements with parent guarantees.

**FIGURE 7: CREATING ALPHA AND REDUCING RISK THROUGH STRUCTURING**

Net IRR Under Various Default Scenarios: With Structure vs. Without Structure




Source: NBAA analysis as of February 2023. For illustrative and discussion purposes only. The Net IRR presented would be net of expected losses, servicing fees, management fees, and carried interest and includes the effects of leverage. This is presented as an indication of expected investment selection and underwriting approach, and not as a suggestion, projection, or guarantee that such returns will be realized or achieved or that an investment strategy will be successful, and they may be significantly different than that shown here. There can be no assurance that the Fund will generate similar returns.

In our view, building all-weather credit portfolios requires not only investing up and down the capital stack, but also lending against a variety of collateral, from home mortgages to receivables, that have the potential to offset inflation's sting and deliver stable, attractive risk-adjusted returns. Finally—and as the recent failures at Silicon Valley Bank and Signature Bank so painfully reminded all of us—we believe investors should always mind the fundamentals, including potentially dangerous asset-liability mismatches that can trigger liquidity crunches.

## Capturing the Flexibility Premium

While private credit markets have evolved dramatically over the last decade, we believe constructing well-balanced portfolios aligned with investors' objectives and shifting market conditions remains a significant challenge. Hurdles include poor price-discovery (which thwarts relative-value assessment across assets and capital structures) as well as the onerous organization and governance tasks that come with managing a diversified strategy and dealing with its dizzying array of cashflows.

At the same time, we believe private credit's inherent complexity and diversity offers investors the opportunity to capture a "flexibility premium". Applied through a broad-portfolio lens, flexible private-credit strategies seek to capitalize on shifting economic cross-currents to deliver attractive returns and maintain optimal risk exposures over multi-year holding periods. In fluid markets, we believe, flexibility wins.

While dynamic private-credit strategies can take myriad forms, we have identified two primary frameworks: "diversified" and "tactical". The central difference is that diversified private-credit strategies generally include a core allocation to all flavors of private credit, including direct lending. By contrast, tactical strategies tend to complement portfolios that already have a core allocation to direct lending by targeting recurring income with lower sensitivity to spread risk. Depending on an investor's goals, a tactical approach might emphasize more niche strategies—from insurance-linked securities and distressed debt, to small commercial loans and intellectual-property finance.

## Conclusion

As private-credit markets continue to expand in size, choice and sophistication, we believe they should play an important role in well-diversified investment portfolios. Furthermore, we think investors should consider taking a flexible approach that incorporates multiple strategies—including **direct lending, capital solutions** and other collateral-backed strategies such as **residential debt** and **ABL**—to meet their goals. Finally, we believe that skilled underwriting and deep domain expertise remain crucial to delivering attractive risk-adjusted returns in this complex yet potentially rewarding asset class.

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