

Your guide to investing in private credit

Enhanced yield versus publicly traded fixed income

Why private credit?

Private credit is a broad, well-established asset class that continues to grow in importance, due to the benefits it can offer investors. It is a diverse space with strategies that range from those focused on capital preservation and income stability, to others with more aggressive total return objectives. Private credit is generally sought out for its enhanced yield or total return potential versus publicly traded fixed income. It may also bring considerable diversification benefits to larger multi-asset class portfolios.

In this guide, we'll address the following:

1. What is private credit and why is it growing so fast?
2. What is an illiquidity premium?
3. What does it take to be a successful private credit manager?
4. What are the key risks associated with private credit investing?
5. What happens when things don't go as planned?
6. What is Mackenzie's view on the future of private credit?
7. What are the key private credit terms to be familiar with?

“Private credit is generally sought out for its enhanced yield or total return potential versus publicly traded fixed income. It may also bring considerable diversification benefits to a larger multi-asset class portfolio.”

Contents

- 03 A well-established asset class
- 04 Return premium for illiquidity
- 05 The need for specialized expertise
- 06 Summary of the key risks
- 08 When things don't go as planned
- 09 Accessible future

A well-established asset class on the rise

Simply put, private credit is lending to businesses by non-bank institutions. The borrower may be a public or private company that requires financing for a strategic acquisition, to fund organic growth or to optimize their balance sheet (most borrowers tend to be private companies).

The borrower might not have access to funds through traditional bank financing and/or debt markets and/or might prefer to work with a lender able to offer more flexible terms, customized structures and faster loan processing.

This form of lending generally serves the “middle market,” an important segment of the economy that includes mid-sized companies that have established proven business models and market positions. These companies exist across all sectors of the economy.

They typically generate between \$10 million and \$150 million in annual EBITDA and are often smaller than the companies that raise capital through traditional debt markets. They generally fall outside the coverage of major rating agencies and therefore do not usually have official credit ratings.

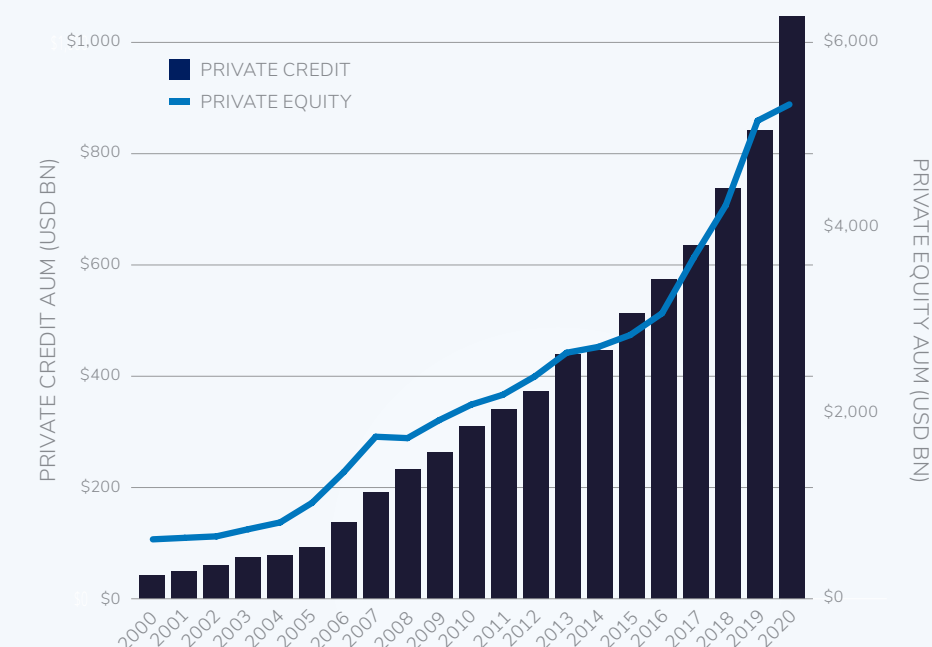
Regulatory reforms after the great financial crisis have restricted the ability of banks to serve this market. This has led to a funding gap that is being filled by alternative credit providers. The rapid growth in private equity activity has also fueled the need for creative, flexible and knowledgeable lending partners, which has further contributed to the expansion of private credit.

The relationship between private credit and private equity

- Private equity firms undertake leveraged buyout transactions.
- These transactions typically use debt financing as part of the capital structure.
- The private equity partners then seek to grow the business and later resell it at a profit.
- The financing required to undertake the transactions is often provided by private credit lenders.

It is important for private credit managers to have a consistent pipeline of attractive new lending opportunities, as this helps them to maintain a diversified portfolio and deliver competitive risk adjusted returns. Strong relationships with private equity firms can often lead to a greater likelihood of a private credit firm participating in a larger number of attractive deals.

Growth of private credit and private equity



Source: Preqin: December 2020

Assets under management in private credit funds has grown from under \$50B in 2000 to over \$1T in 2020

The payback for low liquidity is a higher return premium

Once a private loan is made, it is held by either a single lender or a small “club” of lenders, where each participant holds a significant share of the loan. Because these loans are not frequently traded, the lenders are generally compensated with an “illiquidity premium” – a higher yield than the loan would offer if it was easier to trade. This illiquidity premium may enhance overall returns for investors with longer time horizons.

To accommodate the illiquid nature of private credit assets and ensure the orderly flow of investor capital into and out of these less-liquid securities, private credit funds often offer monthly or quarterly purchases and redemptions and may come with hard or soft lock-up periods and gating provisions.

“Lenders are generally compensated with a higher yield than the loan would offer if it was easier to trade. This illiquidity premium may enhance overall returns for investors with longer time horizons.”

Challenges and opportunities call for specialized expertise

The private credit market is highly decentralized and requires highly specialized analysis to properly understand mid-sized private companies.

This presents both a challenge and an opportunity for providers of private credit. This is especially the case in niche industries where customized debt-financing may only be offered by a small number of lenders.

This can present attractive risk-adjusted return opportunities due to favourable supply/demand dynamics. The ability to continuously source, screen, select, execute and monitor a sufficiently large pool of private credit deals requires a broad platform, a knowledgeable team and extensive relationships.

There are considerable barriers to entry to becoming a viable provider and manager of private credit. Successful managers can build up significant competitive advantages, and investor due diligence is vital.

“The ability to continuously source, screen, select, execute and monitor a sufficiently large pool of private credit deals requires a broad platform, a knowledgeable team and extensive relationships.”

A summary of the key risks in private credit

Private credit funds can be structured for a range of risk and return objectives. Before investing, investors should consider the degree of risk of any given fund along the following dimensions.

Credit risk

This is the probability that a borrower will fail to make full and timely payments of interest and principal, and the expected severity of losses should they occur. Large credit rating agencies generally don't cover private credit, so it is generally unrated. The onus is entirely on managers of private credit strategies to evaluate companies and debt issues for potential investment. Industry and company factors summarized by the 4 Cs offer a view of the potential credit risk in a given portfolio or investment strategy, as does target capital structure positioning.

The 4 Cs of credit analysis:

- Capacity**
A borrower's ability to service their debt. This can be affected by broad industry structure and risk factors, the borrower's profitability, cash flow measures, and level of existing debt.
- Collateral**
The quality and value of the borrower's assets that may be liquidated or monetized to limit creditor losses in the event of default or company bankruptcy.
- Covenants**
The legal terms that spell out obligations and limitations on the actions of a borrower's management team. They are intended to maintain the credit quality of the borrower to the benefit of existing creditors. These may include making regular interest and principal payments, filing audited financial statements and maintaining certain financial ratios.
- Character**
Generally, refers to the nature and intensions of the company's equity holders, the corporate strategy, the management team's track record and governance practices at the company board and operating levels.

Capital structure
A company's mix of debt and equity often includes distinct layers, each with its own seniority in the capital structure. Seniority refers to the priority of any claim on company assets in the event of default or bankruptcy. Debt ranks above equity; secured debt ranks above unsecured debt; and senior debt ranks above sub ordinate (junior) debt.

Higher ranking debt generally receives lower interest rates than lower ranking debt but receives preferred treatment in the event of default or bankruptcy. In some capital structures, specific assets can be pledged as collateral for specific debts. These are referred to as "asset-backed" loans. Secured loans without a specific asset for collateral are referred to as "cash-flow" based loans.



1 Source : Northleaf Capital Partners

A summary of the key risks in private credit (cont'd)

Interest rate risk

Interest rate risk refers to the risk that fixed income securities prices decline as interest rates rise. In the private credit space, debt is generally issued with floating rate payments. Less common are fixed rate payments. Floating rate payments adjust up or down according to the level of a pre-set reference interest rate. This means they are less susceptible to capital losses in a rising rate environment than fixed rate credit investments.

Fund level leverage

In some cases, managers of private debt funds use borrowed money to provide additional exposure to private debt instruments beyond 100% of their fund's net asset value. This leverage will amplify the risk and return characteristics of an unlevered portfolio and comes with its own borrowing cost.

Valuation practices

Because private credit is not actively traded, the valuation frequency and methodology of private credit funds vary. These valuation practices can have a significant impact on the price volatility of private credit funds. Typically, an independent third party is involved in the valuation process to provide an objective opinion.

Investors should familiarize themselves with the valuation practices of a given private credit manager before investing.

Liquidity

Liquidity refers to the ease and speed with which an investment can be bought or sold in the secondary market. Managers of private credit funds typically originate loans themselves and hold them until they are paid back by the borrowers. The average expected holding period of loans inside a private credit fund will affect the amount of liquidity which could be feasible for investors.

It is crucial for investors to understand the liquidity characteristics of a private credit strategy before investing, as this will affect their ability to redeem units should the need arise.

With no active secondary market, it can be difficult and/or expensive for a private credit manager to sell a position to another party to raise cash to fund redemptions. It is in the best interest of investors for private credit funds to offer limited and structured redemption terms aligned with the liquidity of the underlying portfolio.

To improve liquidity for investors, some funds will supplement private credit with more liquid forms of fixed income.

“It is crucial for investors to understand the liquidity characteristics of a private credit strategy before investing.”

When things don't go as planned

Private credit lenders usually benefit from strong legal protection, specifically in the terms, covenants, representations and warranties documented in the credit agreement during the loan origination process. This agreement also provides restrictions, visibility and control over borrower activity.

If the business significantly underperforms to the extent it breaches the credit agreement, the lender and borrower may work to reach a new arrangement. This out-of-court agreement is referred to as a “workout”. It may include restructuring the balance sheet, adjusting the terms of the original loan, injecting equity into the business, increasing the lender’s claim on the collateral, and other measures.

This coordinated activity to resolve an issue can often lead to better outcomes for private lenders. Recourse for investors if things don't go as planned ultimately depends on the business prospects and balance sheet quality of the underlying portfolio companies. This underscores the vital importance of deal sourcing, due diligence, transparency, portfolio construction and risk management in the private credit investment process. In a relatively illiquid market where loans do not carry official credit ratings, manager selection is of utmost importance.

“This underscores the vital importance of deal sourcing, due diligence, transparency, portfolio construction and risk management in the private credit investment process.”

The future of private credit is accessibility

Private credit is generally sought out with the aim of producing better risk-adjusted returns and/or achieving a higher, more sustainable rate of income relative to what can be achieved by relying exclusively on publicly traded fixed income. Historically low interest rates and a growing demand for reliable income leads us to believe private credit will only continue to grow in importance as an asset class.

In the past, private market investments have been out of reach for average investors, but there is reason to be optimistic about the future democratization of this space. Innovations in product design, such as interval funds, are making private credit more accessible and easier to implement, by facilitating enhanced liquidity terms, lowering investment minimums and by removing operational hurdles.

As the capital markets continue to evolve, we are encouraged that a growing portion of the investing public will be able to benefit from alternative investments such as private credit.

“Innovations in product design, such as interval funds, are making private credit more accessible and easier to implement, by facilitating enhanced liquidity terms, lowering investment minimums and by removing operational hurdles.”

Glossary

Buyout transactions: The acquisition of a controlling interest in a company.

Capital calls: The transfer of capital committed in advance by investors to a fund. Where they exist, they can take place over a predetermined schedule or at the discretion of the manager.

Cash flow lending: Financing based on the visibility of a company’s future earnings and the general health of its balance sheet.

Collateral: An asset pledged as security by a borrower to a lender that will be forfeited in the event of default.

Covenants: Conditions included in a lending agreement that restrict the activities of the borrower.

Credit spread: The difference in yield between a low-risk government fixed- income security and another higher-risk fixed-income security with a similar term to maturity but lower credit quality.

Distressed credit: Credit that is in, or soon to be in, default. This also refers to private credit strategies that invest primarily in distressed fixed income securities.

EBITDA: Earnings before interest, taxes, depreciation and amortization – a measure of a company’s financial performance.

First lien debt: The most senior class of debt for companies issuing multiple classes.

Gate provision: A statement outlined in a fund’s offering documents describing the manager’s right to limit or halt redemptions.

Hard lock-up: A minimum holding period before which investor funds cannot be withdrawn from a fund.

Junior debt: Part of a company’s capital structure that sits above equity but below senior debt in terms of priority claim on the borrower’s future cash flows and collateral in case of default. This also refers to private credit strategies that originate and manage second lien debt and mezzanine financing. Secured junior debt is backed by an asset assured as collateral while unsecured junior debt is not backed by any collateral.

Liquidity: The ease, speed and efficiency with which an asset can be bought or sold at fair value.

Mezzanine financing: Mezzanine securities are those structured with elements of equity and fixed income but always reside above common equity in the capital structure.

Middle market: Companies with proven business models, established market positions and \$10-150 million in annual EBITDA.

Opportunistic credit/special situations credit: “Go anywhere” private credit strategies with the ability to deploy capital across the capital structure and credit quality spectrum to harvest returns from rare events.

Private credit: Credit issued by a non-bank entity.

Second lien debt: A class of debt that is subordinate to first lien debt.

Senior debt: The most conservative part of a company’s capital structure, with the highest priority claim on the borrower’s future cash flows and collateral in case of default. Secured senior debt is backed by an asset assured as collateral while unsecured is not backed by any collateral.

Soft lock-up: A minimum holding period before which investors are charged a fee for withdrawing funds.

Workout: A non-judicial process where creditors and debtors meet to alter the original terms of a loan.



igprivatewealth.com / [f](#) / [t](#) / [v](#) / [in](#)

This commentary is published by IG Wealth Management. It represents the views of our Portfolio Managers and is provided as a general source of information. It is not intended to provide investment advice or as an endorsement of any investment. Some of the securities mentioned may be owned by IG Wealth Management or its mutual funds, or by portfolios managed by our external advisors. Every effort has been made to ensure that the material contained in the commentary is accurate at the time of publication, however, IG Wealth Management cannot guarantee the accuracy or the completeness of such material and accepts no responsibility for any loss arising from any use of or reliance on the information contained herein. Commissions, fees and expenses may be associated with mutual fund investments. Read the prospectus before investing. Mutual funds are not guaranteed, values change frequently, and past performance may not be repeated.

This commentary may contain forward-looking information which reflect our or third party current expectations or forecasts of future events. Forward-looking information is inherently subject to, among other things, risks, uncertainties and assumptions that could cause actual results to differ materially from those expressed herein. These risks, uncertainties and assumptions include, without limitation, general economic, political and market factors, interest and foreign exchange rates, the volatility of equity and capital markets, business competition, technological change, changes in government regulations, changes in tax laws, unexpected judicial or regulatory proceedings and catastrophic events. Please consider these and other factors carefully and not place undue reliance on forward-looking information. The forward-looking information contained herein is current only as of 10/31/2022. There should be no expectation that such information will in all circumstances be updated, supplemented or revised whether as a result of new information, changing circumstances, future events or otherwise. Mutual Funds and investment products and services are offered through Investors Group Financial Services Inc. (in Québec, a Financial Services firm). Additional investment products and brokerage services are offered through Investors Group Securities Inc. (in Québec, a firm in Financial Planning). Investors Group Securities Inc. is a member of the Canadian Investor Protection Fund.

Trademarks including IG Wealth Management and IG Private Wealth Management are owned by IGM Financial Inc. and licensed to subsidiary corporations.