

PRIVATE WEALTH SOLUTIONS

Private Credit: Cutting through the Jargon

Private credit as an asset class refers to loans, bonds, and other credit instruments that are issued in private offerings, meaning they do not trade in the public markets.

Private credit is an important source of capital to middle market companies that are critical to the US economy. Since private credit investing relies upon its own unique set of terminology, here we define some commonly used terms and their significance.

Defining the Market

Private credit consists of loans, bonds, and other credit instruments issued in private offerings, which means they do not trade in the public markets. Today, private credit represents 22% of the \$3.7 trillion below-investment grade financing market, up from about 7% of the market in 2005, which then totaled \$1.4 trillion.¹ Private credit represents an important source of capital for the US economy and is a borrowing alternative for companies seeking faster execution of transactions and more flexible terms versus what is offered by public markets. For investors, private credit may represent a source of high income potential and potentially attractive risk-adjusted returns.

Private Credit vs. Traditional Fixed Income

	Private Credit	Traditional Fixed Income
Public / Private	Privately originated and held	Publicly syndicated and sold
Loan Negotiation	Bilateral	Multiple parties
Asset Seniority	Senior Secured	Focus Varies
Coupon Structure	Primarily Floating Rate	Fixed Rate
Credit Rating Process	No	Yes
Call Protection	Yes	Varies
Covenants	Yes	Varies

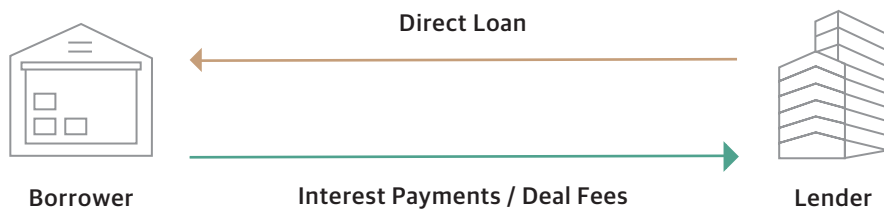
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1. Source: Preqin, Credit Suisse as of December 31, 2020. Total credit market defined as the aggregate of the high yield bond, senior loan, and private credit markets. Senior loans refers to broadly syndicated loans. "Private Credit" is represented by the Cliffwater Direct Lending Index. "Traditional Fixed Income" is represented by the Bloomberg Aggregate Bond Index. For informational purposes only and to illustrate select considerations when comparing fixed income securities. Actual characteristics of individual securities or instruments may vary.

Past performance is not necessarily indicative of future performance. Please see "Important Disclosure Information" for important information regarding performance results and the use of benchmarks.

MAKINGS OF A TRANSACTION

Direct Lending / Private Origination



Definition

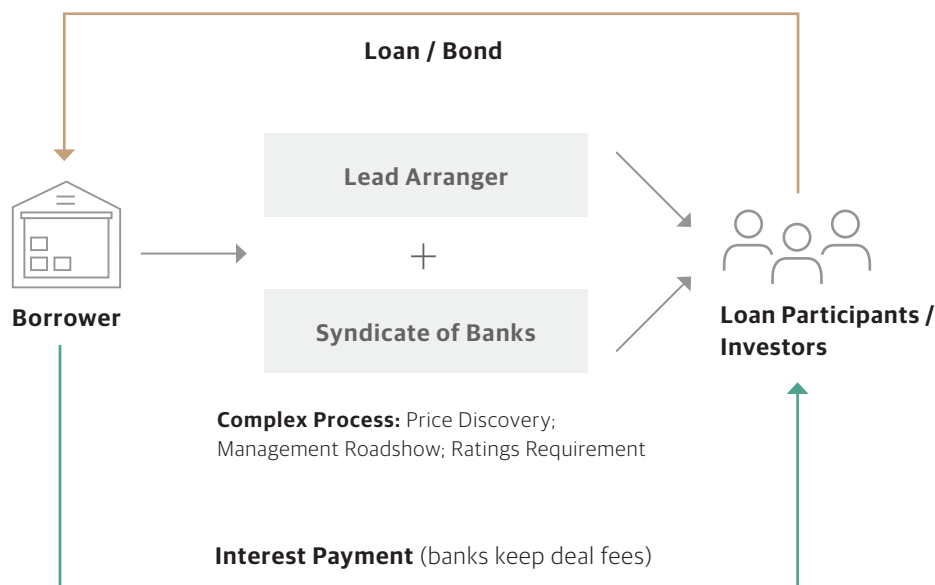
The predominant lending method in the private credit market, direct lending consists of loans made by non-bank lenders directly to a corporate issuer, lenders generally hold these loans to maturity or refinancing. These loans are typically senior in the capital structure, secured by collateral, and typically offer floating-rate coupons.

Why It Matters

This type of loan generally features strong covenants, speed and greater certainty of execution, flexible solutions, and potentially enables more attractive terms for lenders. Direct lending / private origination eliminates the need for intermediaries. A "club deal" structure may result in increased deal flow for lenders and certainty of execution.

MAKINGS OF A TRANSACTION

Public Syndication



Definition

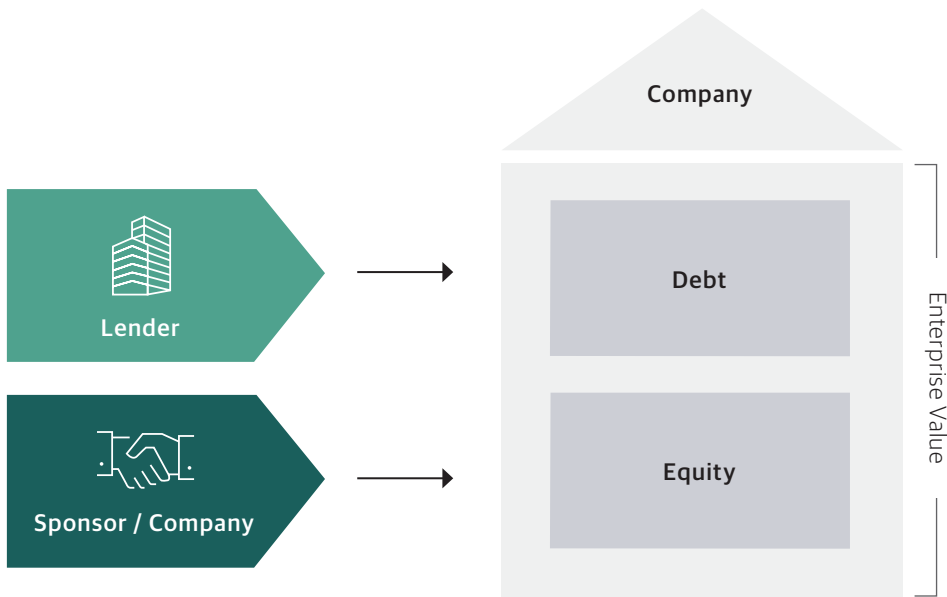
In public syndication, a loan or bond is originated by a lead bank or banks and is syndicated, or sold, to many other investors.

Why It Matters

The public syndication process can be a significant source of capital and time commitment for borrowers, but it also entails costs and potential requirements, such as road shows to attract investors and engagement with ratings agencies. Unlike private lenders, who pass on the proceeds from deal fees to investors, banks keep underwriting / deal fees.

MAKINGS OF A TRANSACTION

Sponsor-Backed Lending



Definition

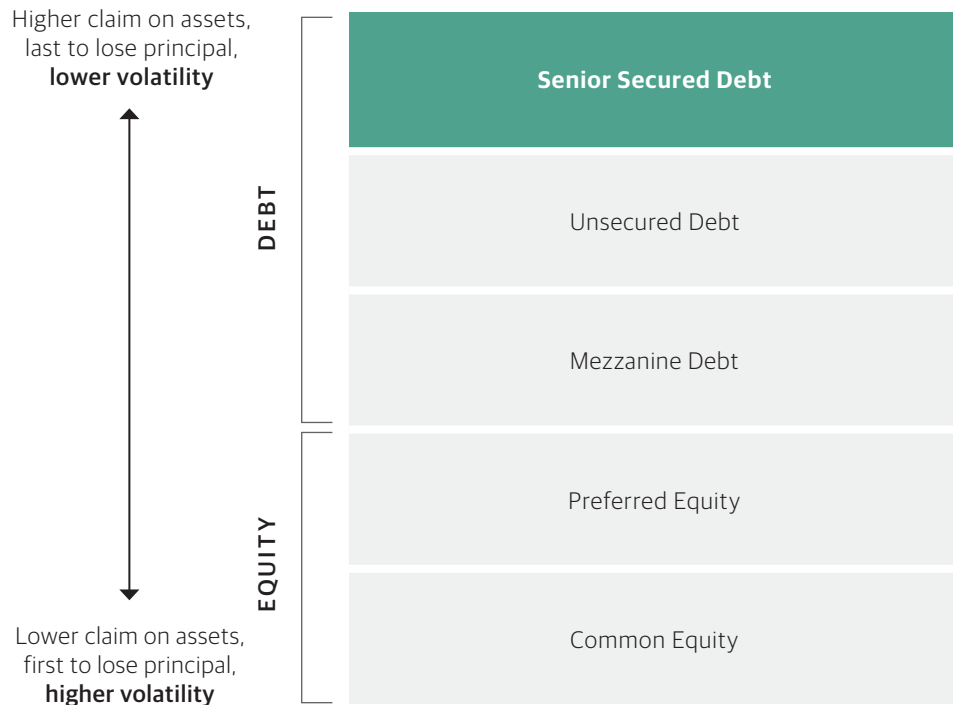
Lending to companies which are owned or controlled by a private equity sponsor ("sponsor"), typically to support an acquisition, refinancing, or recapitalization.

Why It Matters

Sponsors and lenders can work together to strengthen the operations and capital structure of the borrower and increase its chances of success. Sponsor-backed lending can be attractive to private lenders because a trusted equity partner can help mitigate risk. The sponsor's equity stake is subordinate to the private lender's position; sponsors may provide operational support.

TERMS OF THE TRANSACTION

Capital Structure



Definition

A company's capital structure dictates repayment prioritization for the competing interests of owners and creditors, especially with respect to claims on its assets.

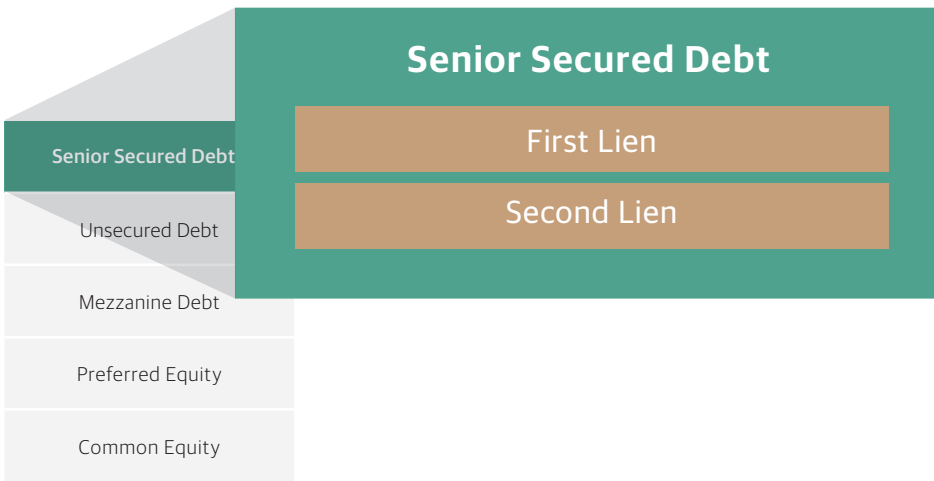
Why It Matters

Repayment prioritization impacts the likelihood of return of capital in the event of default. The lower in the capital structure, the lower the claim on cash flows and the higher the risk of losing principal. Common equity typically occupies the lowest tier.

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TERMS OF THE TRANSACTION

Senior Secured Debt



Definition

Senior secured debt occupies the top of the capital structure and generally has the first claim on cash flows and assets. Within senior secured, companies can make further distinctions between first lien and second lien debt, with first lien debt having the higher claim.

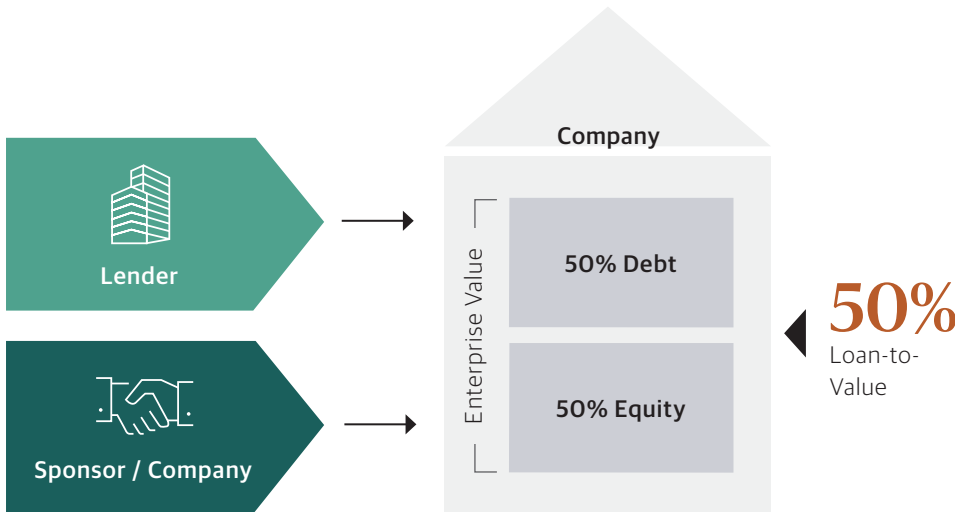
Why It Matters

Senior secured debt is widely viewed as the safest part of the capital structure, as these claims are the first to be repaid in the event of a default.

TERMS OF THE TRANSACTION

Loan-to-Value (LTV)

ILLUSTRATIVE CAPITAL STRUCTURE



Definition

Measures risk in a secured loan by comparing the size of the loan to the underlying value of the company (known as "enterprise value") which is used to secure the loan.

Why It Matters

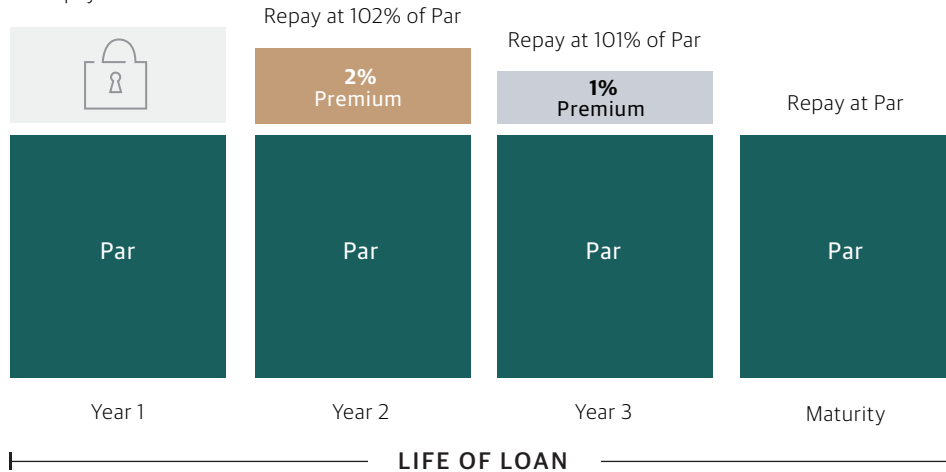
Assuming all else equal, a lower Loan-to-Value ratio indicates lower risk to the lender and any investors. Equity is sometimes described as a loss-absorbing "cushion" to absorb losses. This equity cushion must be deteriorated before lenders are impacted.

Note: The structure referenced above is hypothetical and for illustrative purposes only.

TERMS OF THE TRANSACTION

Call Protection

No Repayment Allowed



Definition

Restricts the borrower's repayment abilities and adds penalties for borrowers who repay the loan before maturity. May provide additional income for investors.

Why It Matters

A typical loan has a 5-7 year term. Call protection restricts repayment for a certain period of time, and after that may provide the lender with predetermined concessions, reducing the potential impact if a borrower decides to pay before maturity.

Note: The structure referenced above is hypothetical and for illustrative purposes only.

TERMS OF THE TRANSACTION

Covenants



Loan Terms

- 1** Maintenance / Financial Covenants
Examples include:
 - Interest coverage
 - Maximum leverage
 - Fixed charge coverage

- 2** Incurrence Covenants
Examples include:
 - Restrictions on debt issuance
 - Dividend repayment
 - Fixed charge coverage
 - Share purchase
 - M&A or divestiture

Definition

Covenants set certain standards that must be maintained by the borrower.

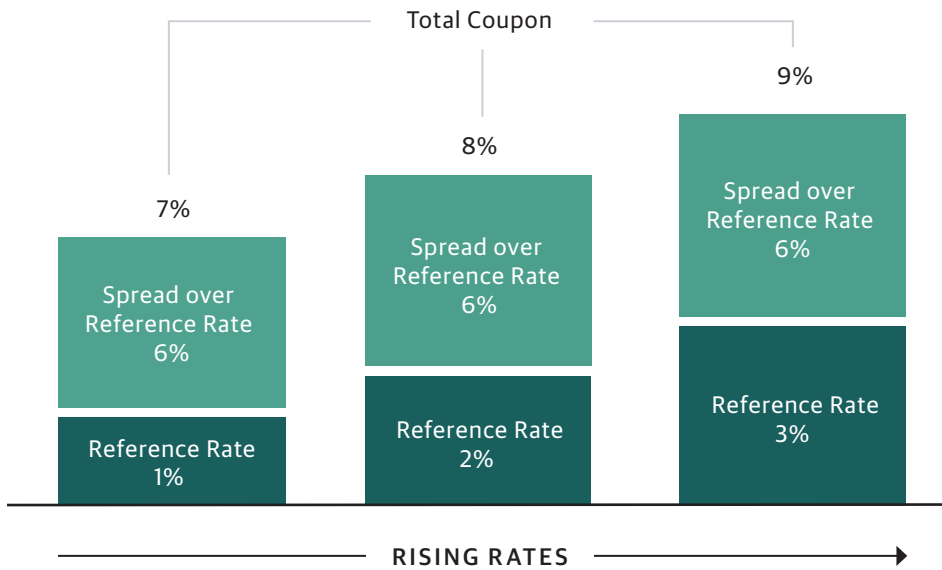
Why It Matters

Lenders can set covenants to ensure the borrower maintains financial health, potentially reducing overall investment risk. While covenants are created to protect the lender, the type, nature, and implications of covenants (or lack thereof) should be assessed within the context of the whole loan agreement.

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COMPONENTS OF A LOAN

Floating Rate Coupon



Definition

Credit instruments whose interest rates are quoted as a spread above a Reference Rate, such as London Inter-Bank Offered Rate (LIBOR) or Secured Overnight Financing Rate (SOFR).

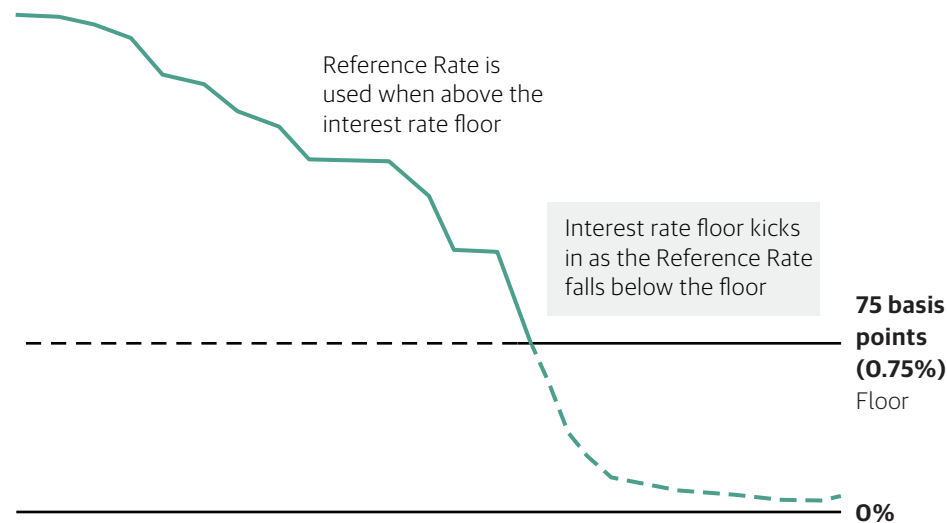
Why It Matters

The total coupon a lender receives fluctuates with the Reference Rate. Floating-rate loans may provide investors greater protection from rising interest rates versus fixed-rate debt. Interest rate floors may be used to protect investors in a declining rate environment.

Note: The structure referenced above is hypothetical and for illustrative purposes only.

COMPONENTS OF A LOAN

Interest Rate Floor



Definition

The minimum level Reference Rate a borrower pays in a floating rate loan. Commonly used Reference Rates include LIBOR and SOFR.

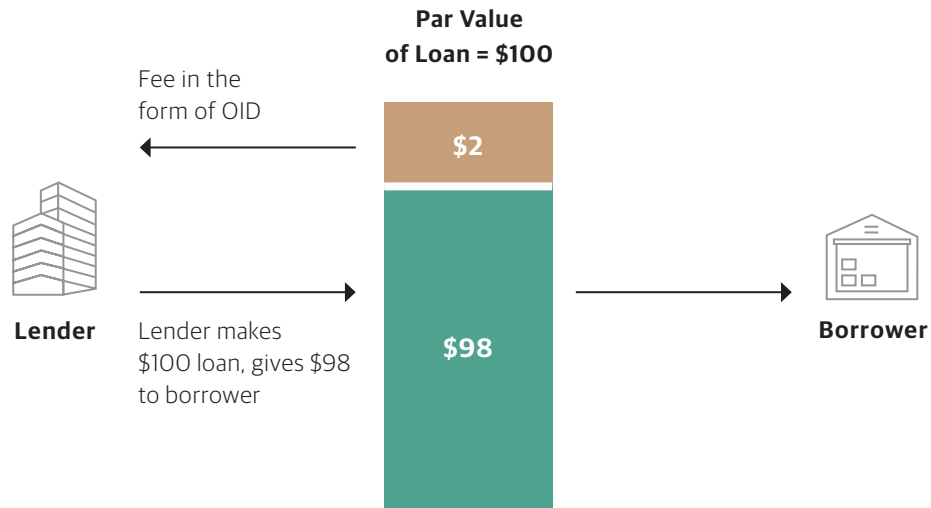
Why It Matters

An interest rate floor can protect investors from a decline in interest rates, as it requires the borrower to pay a specified minimum Reference Rate. In a rising rate environment, the coupon won't change until the Reference Rate rises above the specified floor.

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COMPONENTS OF A LOAN

Original Issue Discount (OID)



Definition

Viewed as a form of underwriting fee on the loan paid by the borrower to the lender at issuance. This may help generate income for investors.

Why It Matters

In private credit, the lender assumes the role of the underwriter and earns the additional income / fee from the OID, which can be passed on to the investor. By contrast, in public credit, a borrower pays fees to an underwriting bank.

Note: The structure referenced above is hypothetical and for illustrative purposes only.

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