bondCAPITAL

Private Credit White Paper

1st Edition

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PRIVATE CREDIT

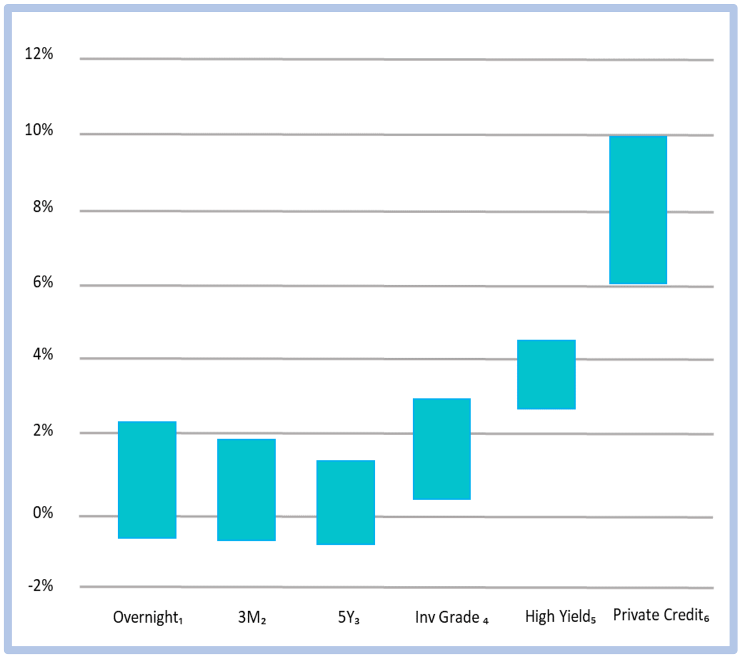
Private Credit an Institutional Private Markets Asset Class

Private Credit History

Private credit's ageless attraction is yield with significantly lower volatility and the benefit of programmed liquidity upon maturity. Private credit features an attractive supply demand dynamic, cash pay current yield, floating interest rate protection, principal protection and sometimes capital appreciation.

While private credit appears to be a brand-new asset category it has existed for centuries. Recent historical events have amplified this growth asset as the provision of private credit (or loans) shifts from banks and or public bond issuances to specialist credit funds.

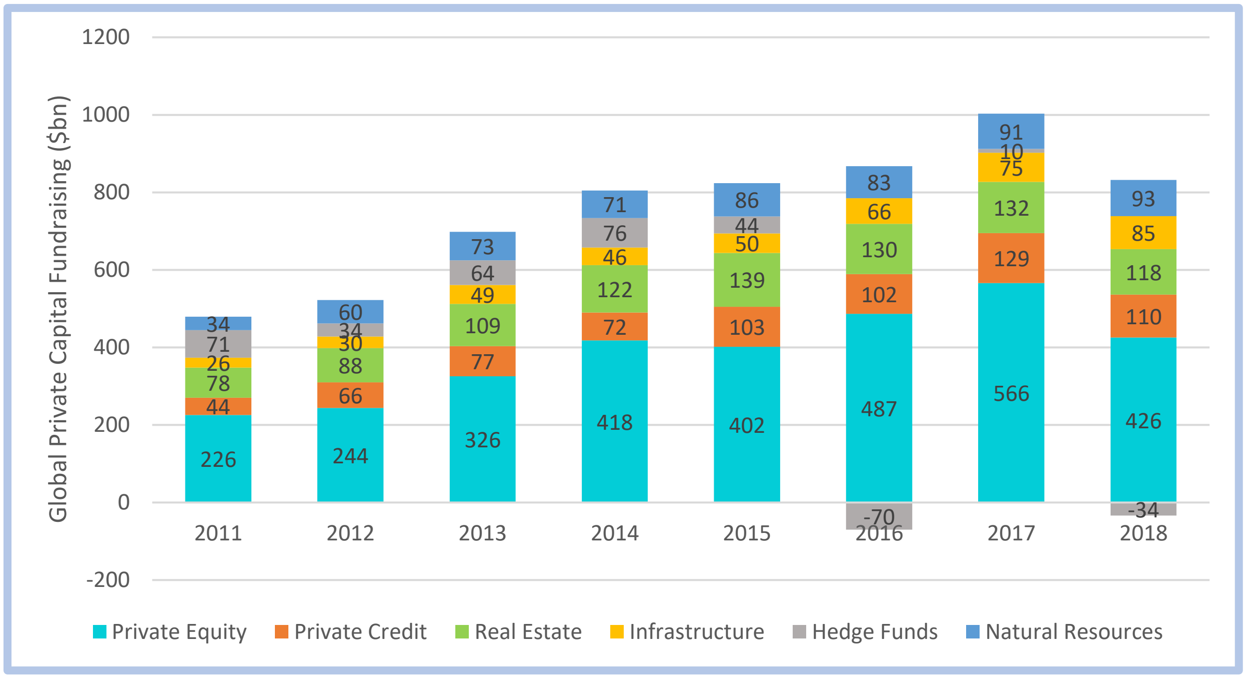
Figure 1. Fixed Income Return



Source: Bond Capital

Since 2008 private credit has been emerging from the shadows of private equity into its own eponymous category within private capital markets (also known as alternative assets). The conditions of historically low interest rates, the convergence of multiple long cycles (credit, bonds, equities, economic, generational, energy and geopolitical) and new capital restrictions being imposed on traditional banks have benefited specialist firms that focus on credit investments. With the emergence of negative real yields, institutional investors and major pension funds started to invest more heavily into credit funds to improve their returns over traditional fixed income investments. After all, interest is meant to be earned not paid.

Figure 2. Global Capital Raised (by fund type)

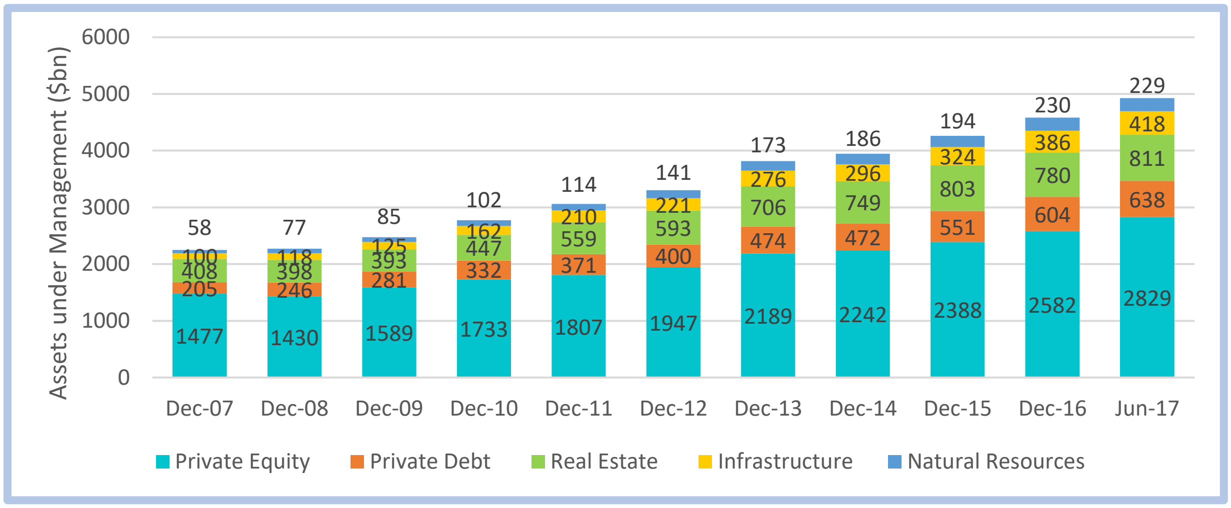


Source: https://www.bain.com/insights/global-private-equity-report-2018/

Just how big is the credit market? Bloomberg has recently reported total global debt of $247 trillion, a figure that they say has doubled since the onset of QE in 2008[1]. That total global debt splits out almost equally amongst government, households, financial sector actors and non-financial corporates making the prospective market for corporate private credit approximately $60 trillion[2]. The banking industry has experienced substantial disruption due to technology, quantitative easing and restrictive government policy being implemented over the past decade such as Basel III. As a consequence, private credit funds have grown substantially taking market share away from traditional banks. Notwithstanding this growth private credit funds are in their infancy. Global private fund capital universe is ~$5.8 trillion[3] and private credit is a composite within that universe. Moreover, the Alternative Credit Council projects private credit will grow to $1 trillion AUM by 2020 up from ~$660 billion today[4] or about 1% of the corporate private credit market.

[1] https://www.bloomberg.com/news/articles/2019-07-15/global-debt accelerated-in-1st-quarter-outpacing-world-economy
[2] IMF World Economic Outlook; national sources; McKinsey Global Institute analysis
[3]https://www.mckinsey.com/~/media/McKinsey/Industries/Private%20Equity%20and%20Principal%20Investors/Our%20Insights/Private%20markets%20come%20of%20age/Private-markets-come-of-age-McKinsey-Global-Private-Markets-Review-2019-vF.ashx00
[4] https://www.aima.org/article/acc-sees-private-credit-market-reaching-1-trillion-by-2020.html

Figure 3. Private Capital Assets under Management by Asset Class, 2007-2017



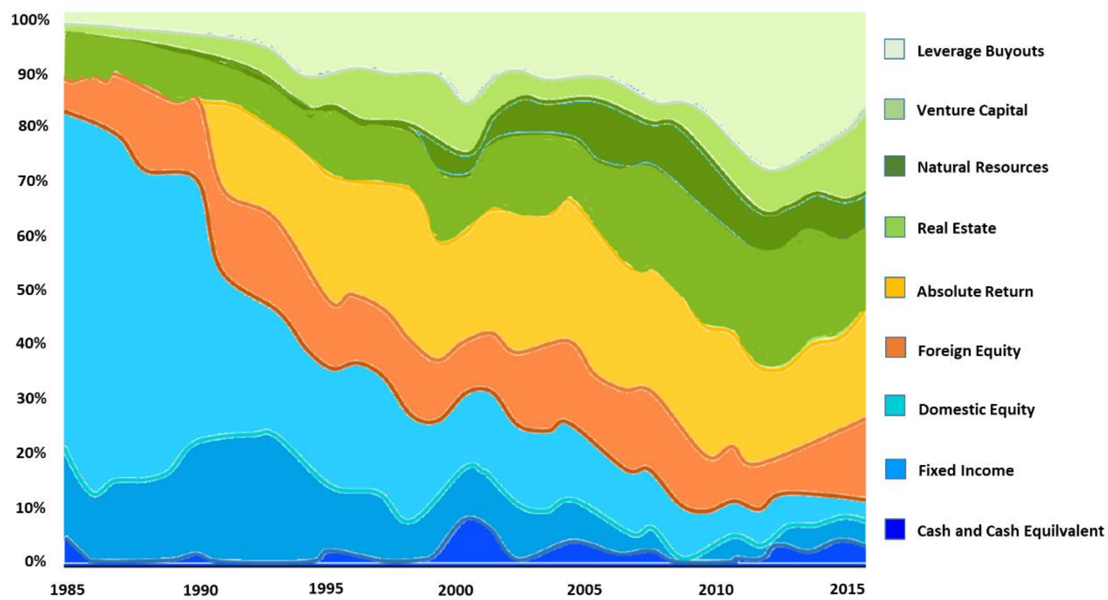
Source: https://docs.preqin.com/samples/2018-Preqin-Global-Private-Debt-Report-Sample-Pages.pdf

As a consequence of superior risk adjusted returns over traditional fixed income, Preqin forecasts that the private credit universe could reach US$2.5 trillion in assets under management in the next 10 years[5].

Notwithstanding its recent popularity private credit has been available since money has existed. Its current form of private partnerships (or funds) originated in the middle of the 20th century when all assets other than public equities and bonds were referred to as private equity and less so private markets or private capital or alternative assets. Following a series of boom and bust cycles more alternative assets came to be included within the private equity universe and ever more capital was being allocated there. The industry was fairly nascent until the US law makers passage of ERISA in 1974 after which annual fundraising ballooned and has continued to grow exponentially right to this day. Despite growth in numerous other forms of alternative assets the super majority of these private capital allocations continued to go to strategies oriented at leveraged buyout and or venture capital until the 1980s. As the private equity industry moved into the 1980s high yield debt came into more common use as a preferred tool in order to complete numerous ever larger global leveraged buyout transactions. Also notable was David F. Swensen's arrival as endowment fund manager at Yale in 1985. Swensen invented "The Yale Model" aka the "Endowment Model" aka the "Swensen Approach" which generated favorable risk adjusted returns ("alpha") through its heavily weighted strategic asset allocations to private market strategies and alternative assets. Empirical evidence indicates that the endowment model is the most viable asset allocation model for long-term investors[6]. Private credit is attractive to long term investors for its ability to provide much wanted yield with capital appreciation and interest rate protection. Adding the alternative private credit asset expands the investment opportunity set and adds diversification benefits with its non-correlation to public equities and bond markets.

[5] https://docs.preqin.com/samples/2018-Preqin-Global-Private-Debt-Report-Sample-Pages.pdf
[6] The Endowment Model and Modern Portfolio Theory", Dimmock, Wang and Yang 23APR2018

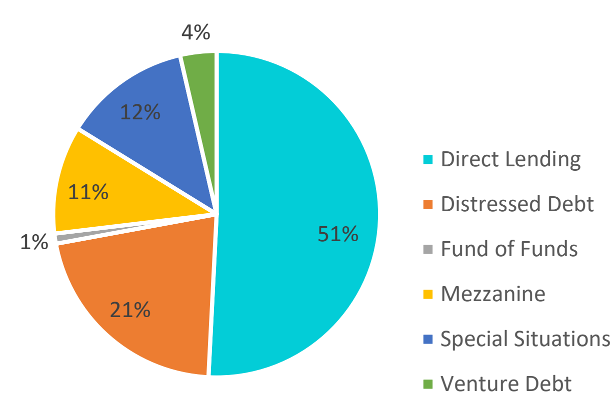
Figure 4. The Change in Asset Allocation



Source: https://internationalbanker.com/brokerage/explaining-yale-investment-models-success/

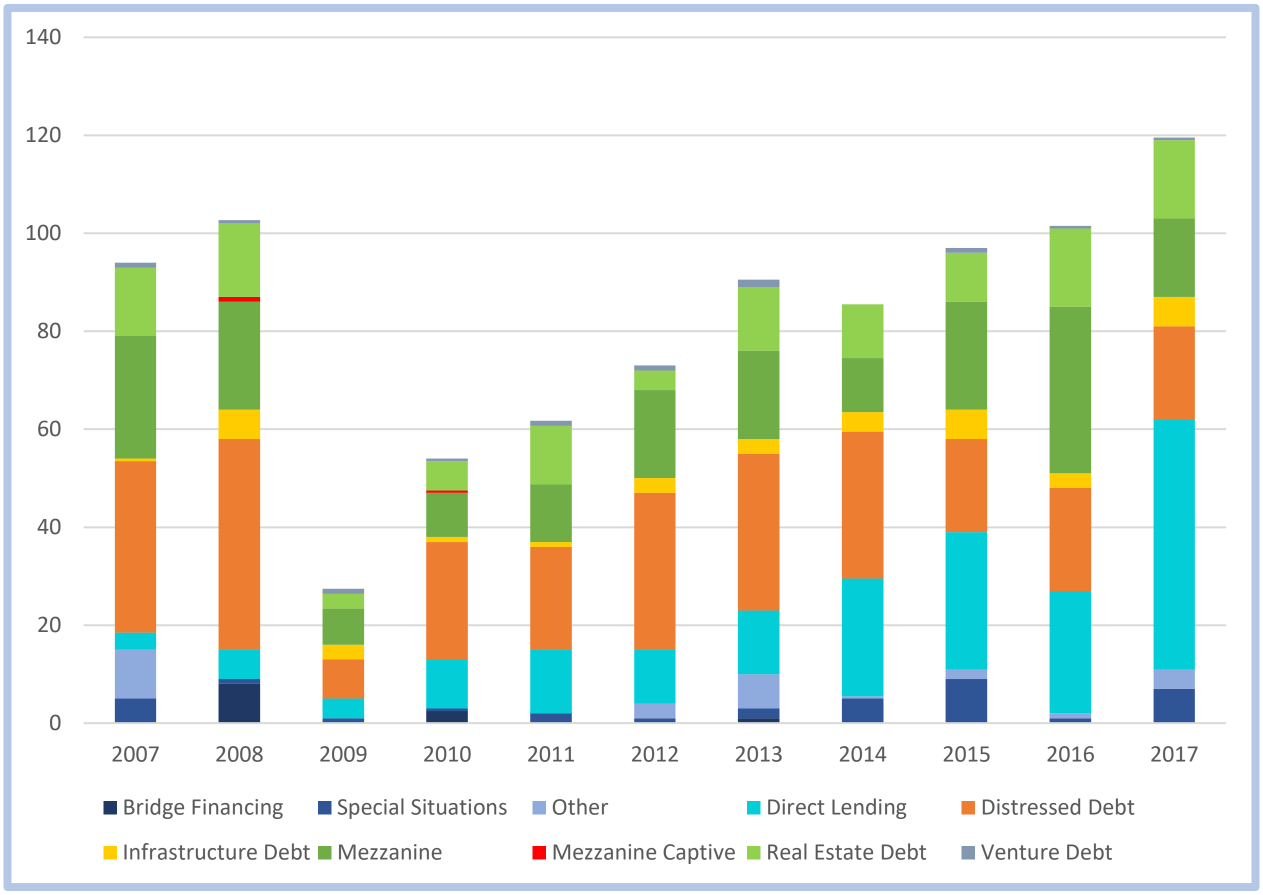
Since 1980 the most common credit strategies have been focused on distressed debt and mezzanine debt. After 2010 with the occurrence of evermore Direct Lending, Distressed Debt, Mezzanine Debt, Special Situations and Venture Debt private credit eventually delineated into its own asset class including the emergence of private debt fund of funds. With the existence of debt segments the term private credit came into vogue as a reference to the asset category in or around 2015.

Figure 5. Private Debt Fundraising in 2017 by Type



Source: Preqin 2018 Global Private Debt Report

Figure 6. Global Private Debt Fundraising by Type ($B)



Source: https://pitchbook.com/news/articles/welcome-to-the-private-debt-show

Today private credit is an asset class comprised of higher yielding, illiquid investment opportunities that covers a range of risk and reward profiles. Institutional investors have significantly increased allocations to alternative fixed income strategies and semi-liquid alternative assets in a search for yield during the persisting low return environment. This asset is also used as a diversification hedge during times of growing economic and or political uncertainty. The strategic allocation to private credit has resulted in a blurring of the line within institutional investors as their fixed income groups (hunting for yield) and their private equity groups (hunting for capital appreciation) are both recommending similar segments of the private credit asset class for their strategic asset allocation. Interest in private credit strategies is increasing further as the long bond cycle is concluding. Institutional investors are learning that private credit will provide satisfactory risk adjusted yield versus comparable bonds, inflation protection through variable interest rates, capital preservation through asset security and in some cases capital appreciation through equity links.

Risk Adjusted Returns in Private Credit

The strategic role for private credit in institutional portfolios is to bring risk adjusted yield and interest rate protection with non-correlated diversity. Private credit is less-correlated to public markets which are getting smaller, riskier and more volatile (see Figure 7 Middle Market Loans).

Private credit has low correlation with traditional fixed income and offers a logical yield replacement with the current $17 trillion in negative yielding bonds[7]. In addition, private credit with its semi-liquid current pay product profile allows long-term liabilities to be more closely paired with interest income.

However, there are numerous strategies and sub-strategies across the private credit spectrum and each has its own unique characteristics. Having an experienced manager with a track record is integral to the asset allocators' success. In addition to strategy and manager consideration the asset allocator must also look at the long-term credit cycle as well as the short-term credit cycles when looking to build out a risk adjusted composite within this asset class.

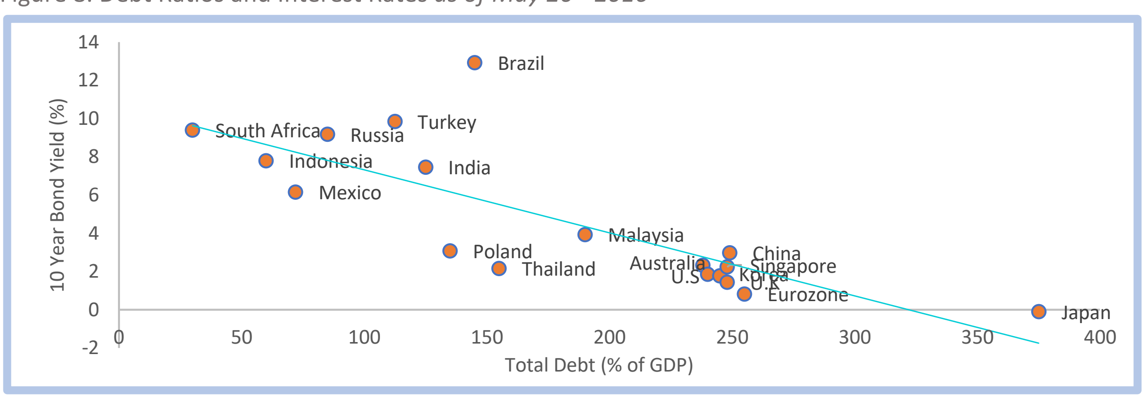
Therefore, when constructing a private credit portfolio, the asset allocator should look to understand the factors that will drive risk and return. The primary factors include credit cycle stage, asset priority or location within the capital structure, asset type, geographical asset location and manager selection. While most common in North America and now Europe private debt can be found in most other geographies as well. The difference between locations is found in the country specific central bank overnight interest rate which is influential in determining the peg for the return on private debt (See Figure 8).

Figure 7. Correlations of Private Debt and Public Assets: 1999-2015

Annualized	Corporate Bonds	High-Yield Bonds	Broadly Syndicated Loans	Middle Market Loans	10 Yr. Treasury Bonds	S&P 500 Index
Corporate Bonds	1.00	0.52	0.38	0.30	0.37	0.12
High-Yield Bonds	0.52	1.00	0.86	0.75	-0.46	0.69
Broadly Syndicated Loans	0.38	0.86	1.00	0.91	-0.54	0.55
Middle Market Loans	0.30	0.75	0.91	1.00	-0.48	0.52
10 Yr. Treasury Bonds	0.37	-0.46	-0.54	-0.48	1.00	-0.64
S&P 500 Index	0.12	0.69	0.55	0.52	-0.64	1.00

Source: S&P LCD, Morningstar, TIAA Global Asset Management

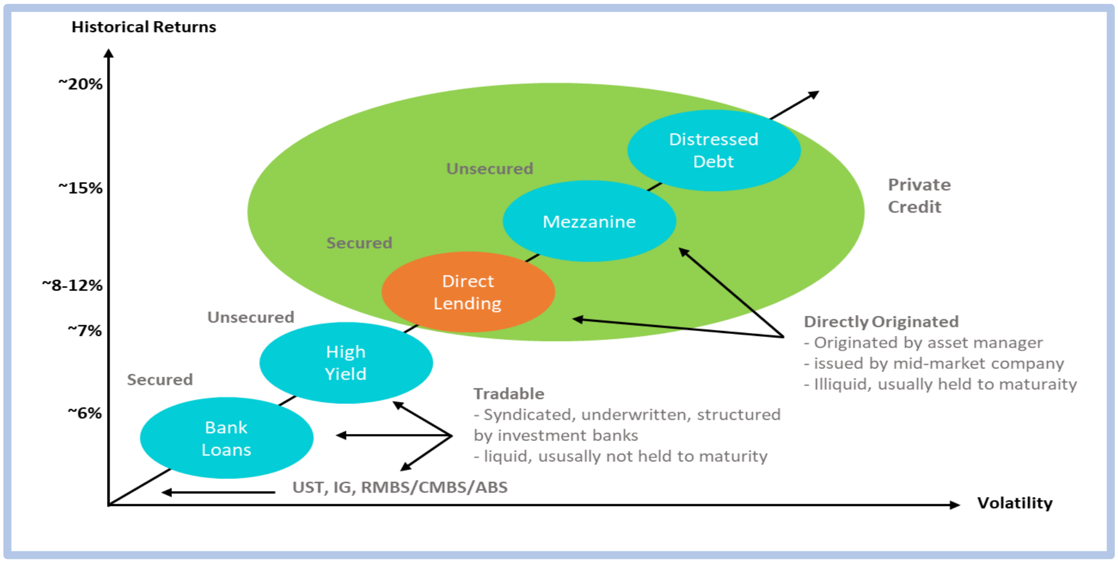
Figure 8. Debt Ratios and Interest Rates *as of May 20th 2016*



Source: Thomson Datastream

[7] Bloomberg, J. Ainger 30AUG2019

Figure 9. Fixed Income Spectrum



Source: https://biws-support.s3.amazonaws.com/Mezzanine/Fixed-Income-Direct-Lending-Marquette.pdf

In addition, certain locations offer creditors more protection than others. Rule of law, knowledgeable commercial judges and auditors are other factors that can differentiate jurisdictions. Diversification factors that should be considered when determining the risk adjusted return include strategy, strata (See Figure 9 above), currency/region, manager, unique loan count, vintage, market opportunity and most recently fund leverage. The long-term median net IRR is 6-10% (See Figure 10A below). According to Pitchbook in 2018 the average net returns for private credit funds was 7.5%. Preqin reported average returns for all private credit strategies at 6.5% for the 5 years to Dec 2018.

Figure 10A. Performance of Private Debt Public Asset Classes: 1999-2015

Annualized	Corporate Bonds	High-Yield Bonds	Broadly Syndicated Loans	Middle Market Loans	10 Yr. Treasury Bonds	S&P 500 Index	Mezzanine Debt
Return	5.63%	6.27%	4.61%	6.21%	4.17%	4.99%	9.99%
Standard Deviation	5.31	10.65	9.06	7.42	3.58	16.67	8.56
Sharpe Ratio	1.06	0.59	0.51	0.84	1.16	0.3	1.17

Figure 10B. Mezzanine Debt Correlations with Private and Public Asset Classes

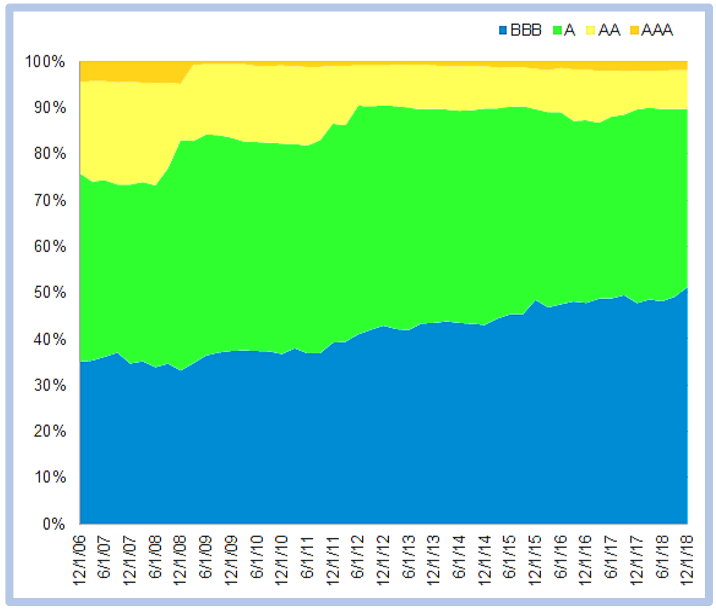
1999-2015	Corporate Bonds	High-Yield Bonds	Broadly Syndicated Loans	Middle Market Loans	10 Yr. Treasury Bonds	S&P 500 Index
Mezzanine	-0.01	-0.12	-0.24	-0.24	0.06	0.07

Source: S&P LCD, Morningstar, TIAA Global Asset Management

Private Credit Strata

Basic credit investing consists of a loan with current pay yield. Stratification of debt instruments refers to the level of protection or security provided to the principal amount. Between the first dollar of debt and the last dollar of equity there is a growing number of credit strata in-between. As with the public bond market, private credit investments have a variety of ratings, level of security, features and duration.

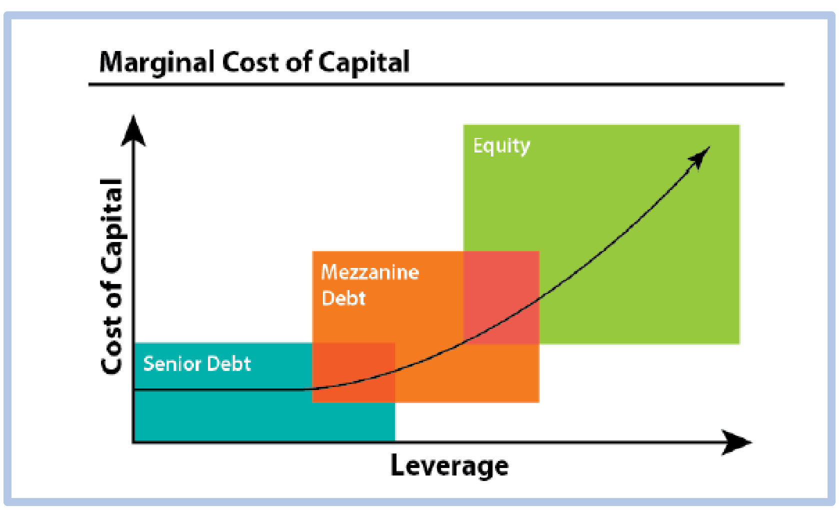
Figure 11. S&P Credit Rating Distribution of US Corporate Bonds



Source: Bloomberg Barclays

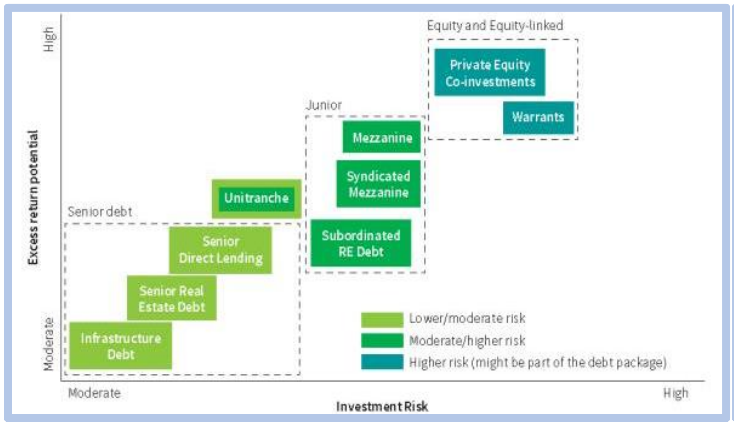
Private credits' differences over high yield bonds include floating rates, lower mark-to-market volatility, better matching of risk and reward, deeper diligence and more diversity with smaller entry points. Furthermore, the incidence of issuance for high yield bonds of less than \$200MM is less than 1% and there is evermore issuance of BBB today than ever before (See Figure 11). Below this private credit facilities can be as small as \$0.5MM with small syndications and or co-investment opportunities ranging from \$25MM to billions. Further up the risk curve second lien, distressed debt and special situations private credit composites with compensatory equity links complement other capital appreciation strategies such as private equity and venture capital.

Figure 12. Marginal Cost of Capital

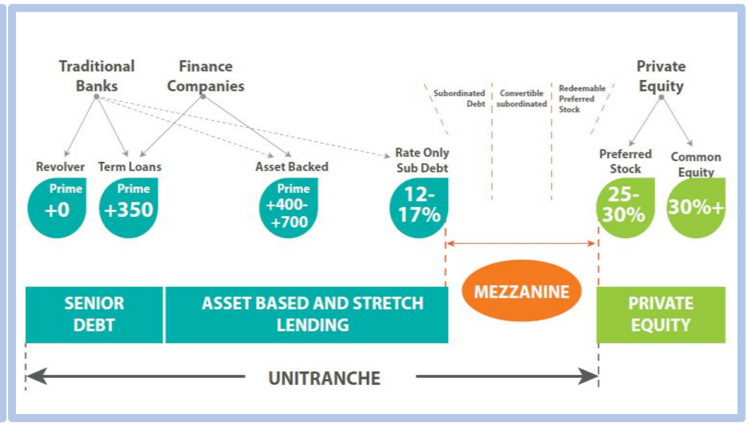


Source: Bond Capital, S&P, LCD, Bain and Company, Private Equity Growth Capital Council

Figure 13. Common Debt Strategies and Their Risk/Return Profile



Source: https://content.markitcdn.com/corporate/Commentary/Get/07082017-In-My-Opinion-The-Rise-of-Private-Debt



Source: Bond Capital, Fitch Ratings

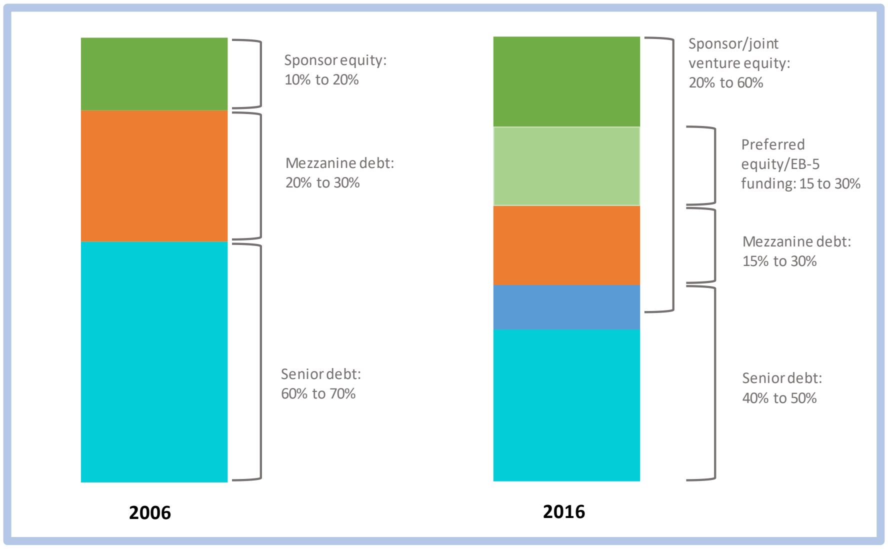
Subject to priority, risk and type, the return profile a private credit will fall into one of six strata of priority as follows:

1. First lien with a priority claim on cash flow and assets;
2. First lien - purchase money security interest (secured against specific assets);
3. Second lien with a subordinated claim on cash flow and assets;
4. Deeply subordinated lien secured by enterprise value;
5. Unsecured Loans; and,
6. Structured equity secured by enterprise value.

In addition to priority, all types of credit are generally correlated with central bank interest rates providing interest rate protection. Priority debt facilities are often amortized over the useful life of the assets they are secured against while junior credit facilities may have minor or no amortization. Figure 13 above provides examples of current rates for certain strata of credit facilities.

Credit facilities that are junior to first lien credit facilities are governed by inter-creditor agreements amongst the various lenders to establish priority in the event of claims on the assets. Asset secured lending is considered to be a lower risk than enterprise value lending which is secured against the value of a business. Subject to priority over other creditors' claims, asset quality and cash flow quality the absolute return for any stratum can range from close to the overnight rate in stratum one to equity return expectations in stratum six. Depending on the credit cycle, stratums expand or contract (See Figure 14).

Figure 14. The Evolution of the Capital Stack

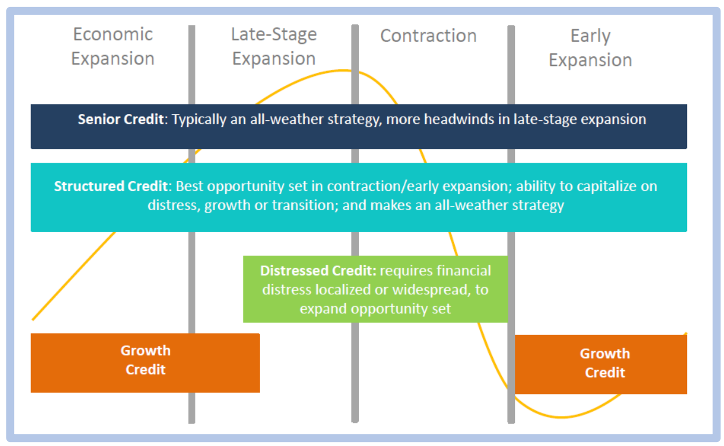


Source: https://www.equitymultiple.com/blog/investingstrategy/mezzanine-debt/

Credit cycle

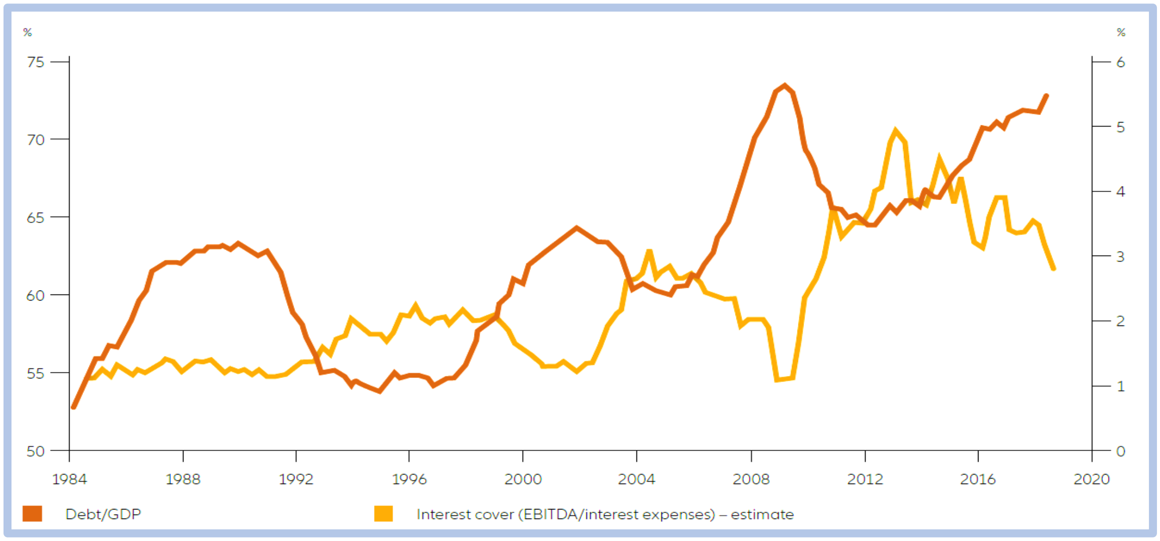
Credit investing will change across both the economic cycle and the credit cycle. At the beginning of an economic expansion senior credit will be generally available and will be supplemented with more junior capital. In later stage expansions senior credit expansion will crowd into junior credit stratums. During an economic contraction senior debt availability will contract and junior and or distressed debt will supplement or outright purchase senior debt facilities at discounts. Finally, during early stage expansions junior capital will replace distressed debt until senior debt becomes more readily available in an economic expansion. Investing successfully across the credit cycle requires dynamic consistency with disciplined understanding of the ever changing economic cycle (See Figure 15 and Figure 16).

Figure 15. Private Credit Strategies across the Economic Cycle



Source: Bond Capital, Cambridge Associates LLC

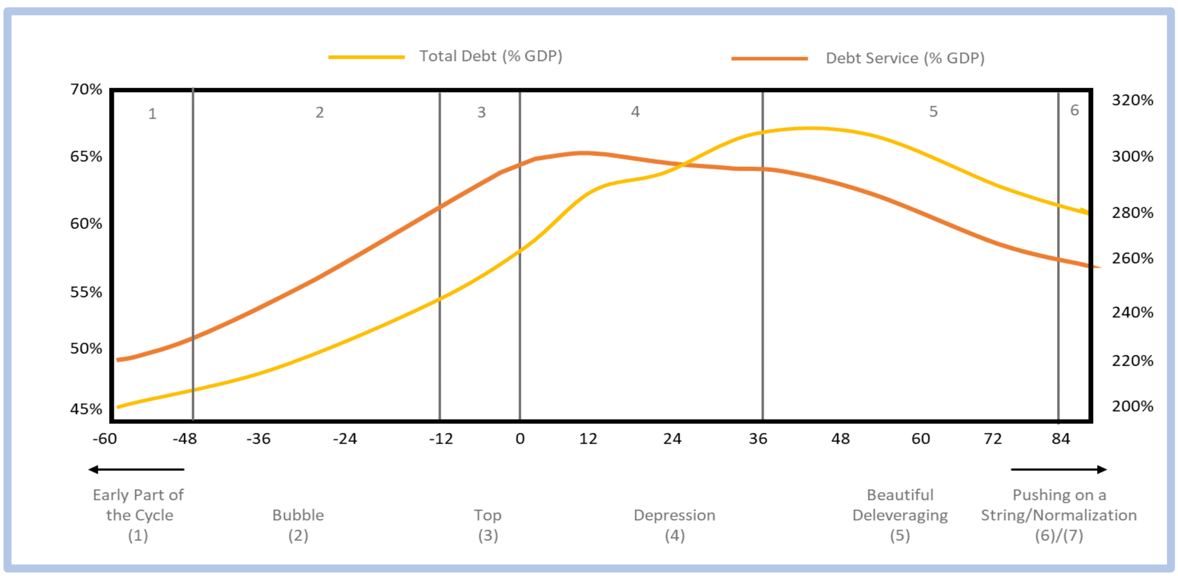
Figure 16. US Non-financial Corporate Leverage VS Interest Cover



Source: https://lu.allianzgi.com/en-gb/pro/insights/update-magazine/the-global-debt-supercycle

In addition to a typical economic cycle, some investors posit that this time around we are seeing the intersection of up to five long term cycles: generational; income equality; the long-term credit cycle, energy source and geopolitical. Today there is a rising risk of recession and cycle change creating need for all weather strategies like private credit. Fortunately, the financial condition of major developed economies are better off than prior to the change in cycle that occurred in 2008. In the deflationary debt cycle case, there will be a prolonged economic contraction and slower and longer early stage economic expansion as bank debt becomes scarce. This event will provide more opportunity for continued growth in the private credit space.

Figure 17. The Phases of the Classical Deflationary Debt Cycle



Source: Ray Dalio, A Template for Understanding Big Debt Crises. 2018

Regulation

As with other types of alternative investments, the regulatory framework for private debt funds differs between the U.S. and Europe. In Europe, many funds are subject to the Alternative Investment Fund Managers Directive (AIFMD), which has been in place since 2014. The AIFMD mandates compliance around transparency of fees, marketing rules to EU investors and investment strategy, among other issues, and requires the appointment of a depository. In the U.S., the regulatory regime has stabilized since the Dodd-Frank Act was passed post-financial crisis. A bill was passed by Congress in May of 2019 loosening restrictions on banks with less than US$250MM in assets, whether this leads to a greater appetite for lending among banks remains uncertain at the present time. Nevertheless, the recent rescinding of requirement for CLO managers to retain 5% interest in the funds issued has provided a boost to the market[8].

While the regulation of private funds is low, the financial crisis of 2008 has heightened banking regulation opening up a longer-term opportunity for private credit investing.

Private Credit Investing

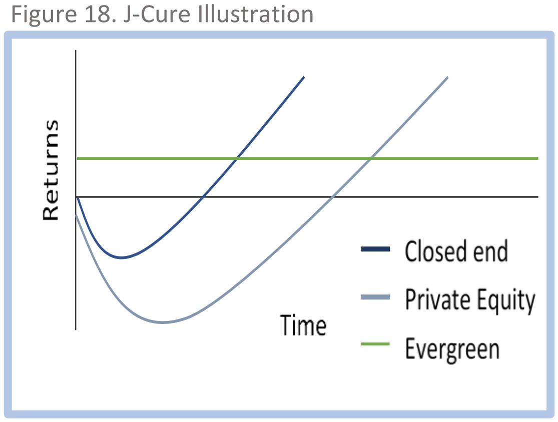
Preqin, an alternative fund asset reporter, started reporting on private credit funds in 2014. The youthfulness of private credit funds has meant that there is a dearth of experienced fund managers. Experienced managers with strong underwriting skills and a broad mandate to manage within and across the credit cycle are best suited to deliver steady returns. Many experienced managers started as junior or distressed credit strategies and have moved into senior and unitranche credits as banks retrenched. It's a difficult space where most newer managers will not have the experience in private credit to successfully work through an economic downturn. Full cycle experience will manifest itself in several ways:

- The ability to understand how to increase legal protections
- The ability and the capacity to act as sponsor
- The ability to manage concentration risks through syndication, secondaries and co-investments
- Return a multiple of capital to investors over short duration IRR's

Managers that operate in primary markets with strong creditor protections and reliable accounting standards offer less risk than emerging markets.

Private credit managers offer various fund types including closed-end, evergreen and separately managed account structures with the manager normally acting as a general partner and the investor acting as a limited partner. Different fund types offer different J-curves

Figure 18. J-Cure Illustration



Source: Bond Capital

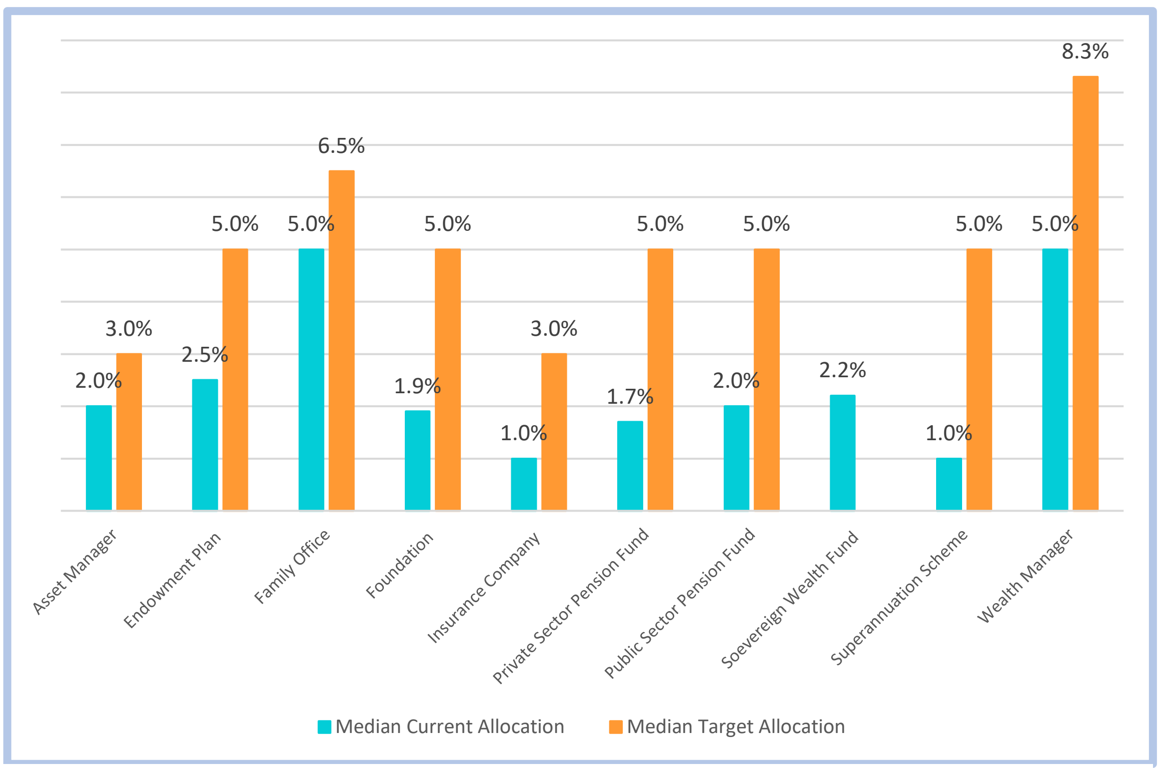
[8] https://www.cibcmellon.com/en/_locale-assets/pdf/ourthinking/2018/ot201809-private-debt.pdf

The asset allocator should know that it takes time to deploy the capital. Most closed end structures will deploy over a three-year to five-year period. Investors should know that the product is semi-liquid and income distributions from the initial loans can contribute to as much as 35% of the limited partners' total commitment vs a deeper J curve for private equity funds (See Figure 19). Evergreen or continuation funds (those that take over investments from prior closed end funds) offer little to no J-curve.

Asset allocators are beginning to formalize allocations to private credit. A target allocation of 5% to 10% subject to strategic return assumptions and risk diversification across both the asset class and stratums will provide for a productive diversified multi manager private credit composite. Investors should plan for a 3 to 5-year window to build the composite. Empirical evidence from the private equity space indicates that smaller funds tend to outperform larger funds.

Managers with demonstrable experience in restructurings, workouts or weathering past periods of turmoil offer a more compelling strategy that resonates with investors in times of uncertainty. Equally important is that experienced managers have an established network of connections which can assist in driving deal flow, buying and selling into secondary markets, effecting turnarounds and managing workouts.

Figure 19. Investors' Median Current and Target Allocations (As a % of Total AUM) to Private Debt by Type



Source: Preqin Pro

Summary

Firstly, there is an attractive supply demand dynamic in the private credit space. On the supply side, total global debt at $244 trillion is at an all-time high having doubled in the past 10 years. Furthermore, BaseI III requires banks to maintain a higher quality and quantity of capital on their balance sheets. This means Banks will shrink their loan book to increase their capital base making more room for private credit. On the demand side, quantitative easing programmes in Europe and North America have borrowed future returns by over-inflating valuations of traditional assets such as equities and bonds, driving investors in search of yield and preferably decent risk adjusted yields. Thus, future returns are bound to be lower for all asset classes, while private equity and private debt are expected to deliver superior returns.

Secondly, there is a track record of performance with yield. Private credit strategies have provided higher yields when compared to fixed-income indexes. Between 1997 and 2014 private credit outperformed both the global high yield index and the US investment grade index. As a result of satisfactory investment returns institutional investors have gravitated toward private credit over the past several years – a global survey revealed that 91% of institutional private credit investors plan to maintain or increase their allocation over the longer term. Institutional investors have leaned on private credit to overcome some of the many persisting obstacles that the financial crisis of 2008 brought to the forefront. The versatility of private debt has institutional investors utilizing the asset class ever more. To illustrate, a recent survey of institutional investors found that more than a third of portfolio managers already have a distinct allocation within their portfolio[9].

Thirdly, the diversification is appealing. Private credit is perceived as a cross-over asset: one with equity-like returns and bond-like volatility, and very low correlation with other asset classes. In addition, the public and private market inefficiencies associated with increased volatility and lack of liquidity present opportunities for skilled active managers to enhance risk-adjusted returns. It is interesting to note that after the 2000-02 bear markets, investors intensified their search for uncorrelated absolute returns by diversifying into alternatives such as hedge funds, private equity and real estate. The 2008 credit crisis showed all too clearly that, in a bear market, correlations between all asset classes can surge while liquidity dries up without any illiquidity risk premium. Since then, the search for uncorrelated absolute returns with an illiquidity premium has significantly narrowed to esoteric asset classes such as infrastructure, wind farms, farmland, shipping finance, catastrophe bonds and private debt.

Finally, one cannot overlook the defensive nature of private credit. With a skilled experienced manager due diligence is rigorous, loan terms are customised, and investors have a prior charge on a borrowers' hard assets compared with unsecured investments, equity investments and traditional fixed income investments. Capital protection is a big plus for institutional investors during the late stages of an economic cycle and or a credit cycle and when volatility is heightened for whatever reason. Private credit is a reliable all-weather asset class.

[9] Preqin Investor Outlook: Alternative Assets H2 2017.

About Bond Capital

Bond Capital is an award winning institutional provider of structured business debt and equity to successful business owners and management teams wishing to capitalize for growth, acquisitions, or buyouts. As a true entrepreneurial partner, Bond Capital identifies common goals and objectives, tailors a creative total financial solution, and provides the necessary investment in real dollars. Since 2002, Bond Capital has provided funding and advice to later stage companies with strong management teams and EBITDA between $2 million and $50 million, making direct investments between $2 million and $55 million. Bond Capital has also arranged syndicated transactions ranging up to $250 million.

Bond Capital was named by Preqin for best global performance by a private debt fund from 2015 to 2020. Bond Capital is located in Vancouver, Canada.

About the Authors

Corry J. Silbernagel, PEng, MBA
understands how to determine the right mix of debt and equity to amplify investee companies' success using cash flow analysis and other tools. As managing director and head of originations at Bond Capital, Corry is responsible for new investment opportunities.

Corry's strong operational finance skills come from twenty years working as a management consultant, CFO, project engineer, and engineering project manager at some of Canada's largest energy companies and for a leading global engineering firm. Corry enjoys participating as a board member and treasurer for various public companies, private companies, and not for profit organizations.

Davis V. Vaitkunas, BComm
has spent over twenty years advising business owners about finance, capital structure strategy, raising capital, and the cost of capital. Davis has funded over 250 transactions using a wide variety of creative capital solutions. As the founder and managing partner of Bond Capital, Davis has successfully raised and deployed multiple Bond Capital private equity funds.

In addition to being a banker, Davis is a successful entrepreneur who understands sales. He formerly worked in the information technology industry implementing enterprise resource planning (ERP) software, hardware, and network solutions for manufacturing and retail clients at a Global 100 Corporation.