INVESTMENT INSIGHTS

The four myths of private credit

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New York Life Investments

Our multi-boutique business model is built on the foundation of a long and stable history, which gives our clients proven performance managing risk through multiple economic cycles. With capabilities across virtually all asset classes, market segments, and geographies, our family of specialized, independent boutiques and investment teams allows us to deliver customized strategies and integrated solutions for every client need.

Our investment managers offer deep domain expertise and diversity of thought, generating deeper insights alongside a strong conviction to deliver better outcomes.

This piece explores private credit investing with investors at Apogem Capital, Kartesia, and our Multi-Asset Solutions team.

In the wake of an unprecedented economic cycle, we have noticed an uptick in investor questions regarding direct loans. Supply chain imbalances, higher raw material costs, rising interest rates, labor shortages, and geopolitical risks each contribute to business risk — and therefore to credit risk. Investors are prudent to consider how these risks will play out in their portfolios.

In our conversations with investors, we have identified four common concerns — our "four myths of private credit"—that we believe need not influence investors' allocation to the asset class. On the contrary, oft-cited objections can be a source of investment strength with the right partners. This piece explores those objections with subject matter expertise from private credit investors Apogem Capital and Kartesia.

The four myths of private credit

Myth 1:
Rising interest rates are a threat to the asset class

Myth 2:
Slowing economic growth will lead to higher defaults

Myth 3:
The middle market is riskier

Myth 4:
Sponsor-less deals are riskier

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Myth 1:
Rising interest rates are a threat to the asset class

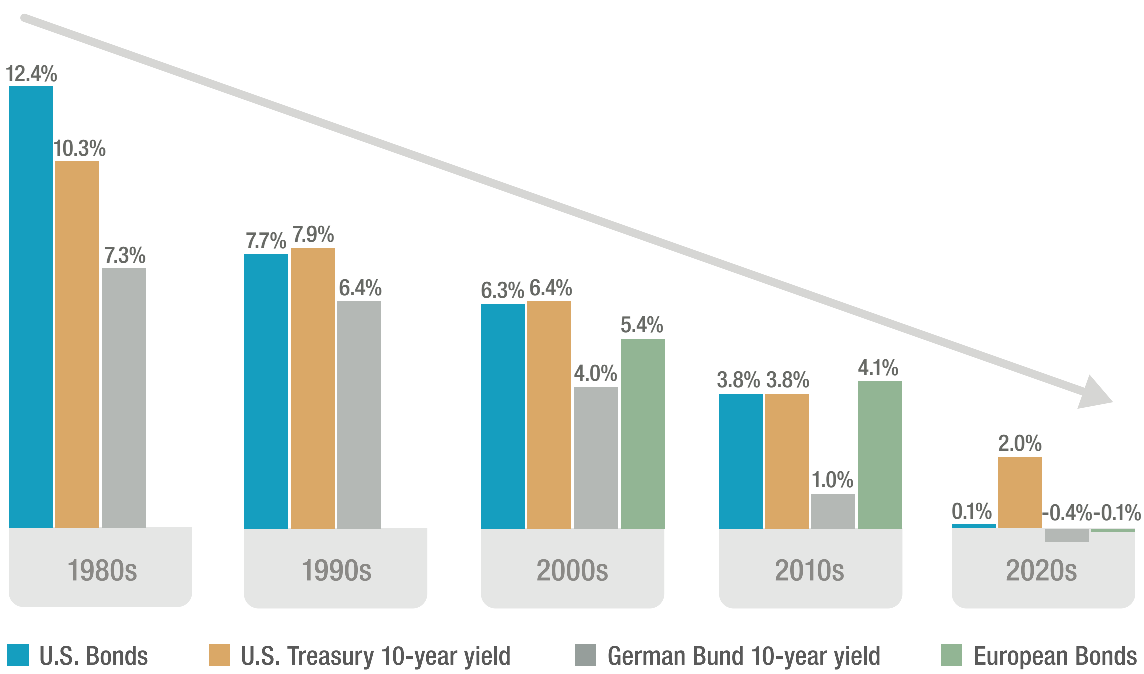
The COVID-19 pandemic disrupted supply and raised demand for raw materials, goods, and labor. The resulting higher inflation is putting pressure on central banks to raise interest rates globally. As interest rates rise, investors may see a valuation re-rating across asset classes, impacting asset allocation. Higher rates may also increase portfolio companies' capital costs, influencing security selection.

That said, we are not concerned about rising interest rates in the context of a direct lending portfolio for several reasons:

The asset class is floating rate. Private credit is a floating-rate asset class, meaning the loan's coupon rate resets or "floats" with the current level of interest. As a result, the asset class has virtually no duration risk making it well suited for a rising rate environment. In addition, our managers' loan portfolios use senior secured loans, which have the first position in the capital stack, leaving them strategically well-positioned to recover collateral should risks arise.

Higher inflation rates do not mean high-interest rates. Even as expectations for interest rates have risen, we expect interest rates are likely to remain low by historical standards. In the U.S., where inflationary pressures are most pronounced, estimates for the 10-year Treasury yield at the end of 2023 are between 2% and 3%. In Europe, where policy rates are still negative, the figure is between 0% and 1%.

Investor yields have been declining for decades.



Sources: New York Life Investments Multi-Asset Solutions team, Bloomberg Finance LP, as of 3/15/22. U.S. bonds are represented by the Bloomberg U.S. Aggregate Bond Index and European bonds are represented by the Bloomberg Euro Aggregate Bond Index. Results for the Euro Aggregate Bond Index were not available before 1998, and therefore are not included until the 2000s. Index definitions can be found at the end of this piece. Past performance is not indicative of future results. An investment cannot be made directly in an index.

Portfolios are built for rate resiliency. Most borrowers have a LIBOR, SOFR, or EURIBOR floor in their borrowing costs. This means that rising policy rates will generally not have an impact on borrowers' cost of capital until interest rates rise above the relevant level. In the U.S., a LIBOR or SOFR floor of 1.0% is common. Once interest rates exceed that level, careful credit analysis tests for cash flow to cover higher interest costs. European borrowers have experienced a similar dynamic. With 3-month EURIBOR in strongly negative territory and interest rate floors at 0.0%, the planned small increases in policy rates are unlikely to impact borrowers.

In addition, the structure of direct loans allows for more flexibility through shifts in a company's operating environment. For example, in a broadly syndicated loan, it can be challenging to convince all lenders to agree to changes in terms. Direct lenders can be agile in supporting their borrowers, with the goal of building stronger and more resilient companies for the long term.

Most of our borrowers in the U.S. and Europe have LIBOR, SOFR, or EURIBOR floors in their borrowing costs. This means that rising policy rates will generally not have an impact on borrowers' cost of capital until interest rates rise above the relevant level.

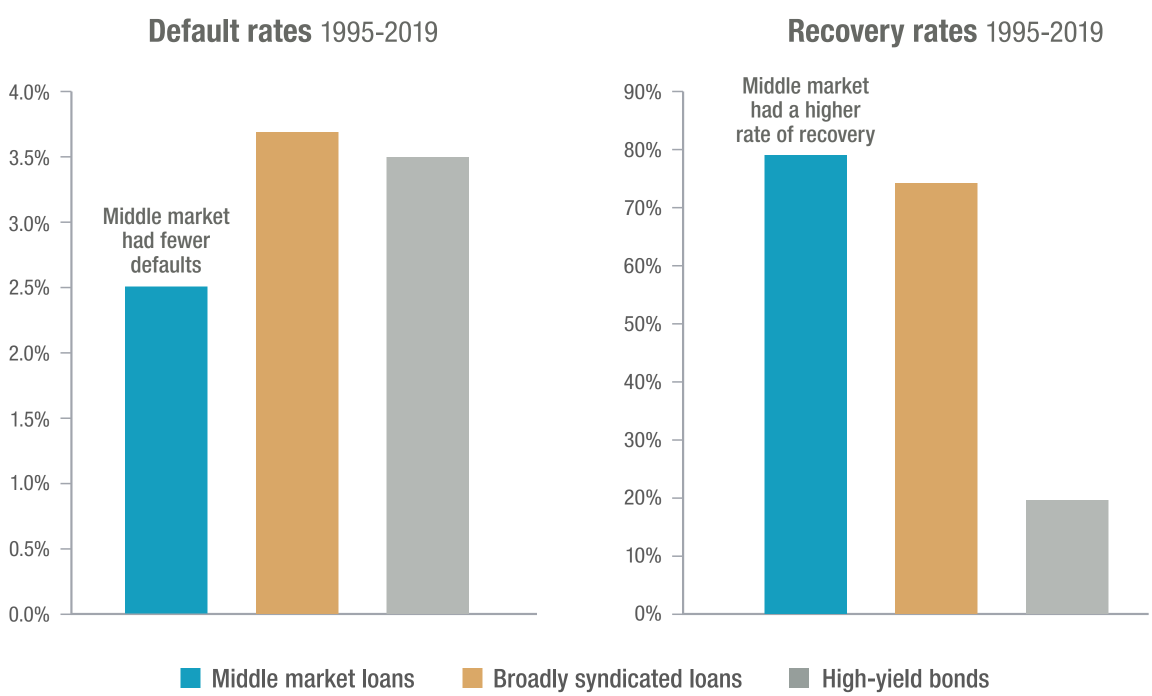
Modest interest rate increases can help reduce cost pressures elsewhere. Central banks are likely considering interest rate increases to help tame imbalances between supply and demand. Those same imbalances have historically impacted borrowers through higher labor costs and increased raw material prices. While rising interest rates will likely impact demand, reduced cost pressures and more predictable business conditions may potentially offset some of that impact.

Myth 2:
Slowing economic growth will lead to higher defaults

If rising interest rates are manageable, investors may still wonder if slowing revenue growth would be. Certainly, slowing economic growth and softening demand can weaken borrowers' ability to manage rising costs. In our view, navigating the ebb and flow of macroeconomic cycles comes down to credit selection, portfolio construction, and manager value-add.

Credit selection. Direct lending is a long-term investment, with funds often targeting 5, 7, or even 12 years of invested capital. Changes in the macroeconomic environment, and the arrival of unexpected risk, are likely to occur in those time frames. As a result, underwriters work to understand a borrower's demand drivers, cost structure, and sensitivity to impacts to those drivers. This deep understanding of a borrower's creditworthiness helps not only in making the proper security selection and investment structure, but also in the ability to take a proactive stance in supporting borrowers when risks arise. The capital structure, collateral, and covenants that our investors require create room for the risks that arise.

Historically, middle-market default rates have been lower and recovery rates have been higher when compared to similar asset classes.



Sources: Mercer, S&P Credit Pro, 2021. The "middle market" and "broadly syndicated" market default and recovery rates are calculated by S&P Global Market Intelligence research. High-yield bonds are defined by the S&P U.S. High Yield Corporate Bond Index. Index definitions can be found at the end of this piece. Past performance is not indicative of future results. An investment cannot be made directly in an index.

Portfolio construction and diversification. The middle market provides a large universe of businesses with funding needs, allowing our managers to be selective in whom they include in a portfolio. Our portfolios have been particularly resilient to changes in the macroeconomic cycle due to overall portfolio diversification and avoiding highly cyclical or trend-based sectors. Apogem Capital, for example, has historically avoided sectors such as oil and gas, hospitality, and retail within its private credit portfolios, while prioritizing specialty silos such as insurance and financial services, healthcare, and software and technology, based on revenue reliability and earnings quality. Similarly, when constructing a portfolio, the Kartesia team focuses intensively on diversifying across industry and geographies, assessing borrower liquidity and transparency, and avoiding credits with highly binary outcomes (i.e., those likely to perform very well or very poorly).

In the event of a more significant economic slowdown, our managers have the proven ability to proactively identify and support borrowers through any issues that arise.

Manager value-add. In the event of a more significant economic slowdown, our managers have the proven ability to proactively identify and support borrowers through any issues that arise. This demonstrated flexibility and support can sustain enterprise value where public investment vehicles cannot. In addition to making the asset class more attractive in our view, this value-creation approach can help minimize the risk of default and maximize recovery values.

In addition, data suggest that public markets are more susceptible to volatility. While their liquidity allows investors the flexibility of entry and exit, it can magnify risks. Active portfolio monitoring and management[1] allows our investment teams to provide borrowers with flexibility when they are struggling.

Finally, while periods of reduced economic activity can mute transaction volume, managers can also provide the opportunity to negotiate for improved credit terms or generate amendment-related fees. Lower transaction volumes can also reduce portfolio run-off and create opportunities for portfolio accounts to make add-on acquisitions at more attractive valuations.

Myth 3:
The middle market is riskier

Investors, particularly those outside the U.S. and Europe, have sometimes expressed concern that the middle- and lower-middle market segments of private credit are riskier than other segments. For experienced investors, this simply need not be the case. A few key characteristics of the middle market leave us confident in the opportunity there:

Investor positioning. Our managers are senior secured lenders, taking the first position in the capital stack and, thereby, increasing the odds and amount of recovery in the event of a default.

Large universe of quality companies. The middle market includes a large universe of diversified companies, allowing our investors to select a priority subset of names that can potentially outperform the segment's average risk and return.

Relationship-driven market. The middle market, and particularly the lower-middle market, is strongly relationship-focused. Our managers have a long track record in middle market private credit, giving us an incumbency advantage in originating and securing the most attractive deals. Our teams have established deep connections in the marketplace with sponsor and owner-managers. Through these ongoing relationships we have developed a reputation for being capable of coping with deal complexities. In many cases, this has allowed our investment teams to become the counterparty of choice.

In turn, this market positioning provides our investment teams with more access to diligence, information, and direct communication with company management and sponsors than that afforded by the larger market. It also allows our investment teams to support operational and business development as companies grow and navigate economic cycles.

Attractive yield. In exchange for the due diligence, legal know-how, and expertise that management teams must bring to the middle market segment, investors may be correspondingly rewarded. Over the last 15 years, middle market loans have outpaced large corporate loans by a spread of 77 basis points.[2] These market-level figures may understate the opportunity provided by managers with a long track record of middle- or lower-middle market lending.

The middle market for private credit is strongly relationship-focused. Deep connections and a long track record may allow managers to access more information, navigate operational complexity, and originate more attractive deals.

Myth 4:
Sponsor-less deals are riskier

Both sponsor-driven and sponsor-less deals have benefits to investor portfolios. While the approaches differ, one need not necessarily be riskier than the other. Instead, investors must assess which approach is best suited for the geography and segment they are considering for their portfolio.

In Europe, for example, sponsor-less deals make up the large majority —nearly 90% —of the universe of lending opportunities available. In other words, by focusing on the sponsor-less market, investors expand their investment universe by nine times. In our view, this allows our investment teams to avoid compromising on quality of management teams, information provided, collateral secured, and other essential investment items.

In the U.S., on the other hand, a more mature and highly competitive market means that sponsor partnerships can offer distinct competitive advantages under the right circumstances, particularly when leveraged over a long investment track record and with strong investor relationships.

In both cases, choosing the right opportunity for the market, and the right partners for that opportunity can contribute positively to investor results.

Potential positives of sponsor-driven and sponsor-less deals, assuming experienced partner selected:

	Sponsor-driven	Sponsor-less
Discipline	Sponsors care about their reputation with preferred lenders, encouraging more discipline in the sourcing and due-diligence process.	Sponsor-less deals often require heavier financial covenants and more attention to collateral, including cash flow and hard assets on hand.
Risk management	Sponsor partners often provide third-party due diligence.	Leverage levels are often lower.
Recovery	Patient, committed capital gives private equity sponsors the ability to assist businesses through incremental capital investments to support growth or in times of distress.	Sponsor-less transactions often have an extra layer of interest alignment, as sponsor-less companies' management often take further steps to preserve their credibility and/or family history. For them, the deal is about more than the loan.
Transparency	Sponsors have their own lens into the breadth and depth of portfolio companies and can be called upon for insights and deal flow.	Negotiating with sponsor-less companies provides a structural advantage, potentially allowing for better terms or bespoke opportunities.

CIO perspective

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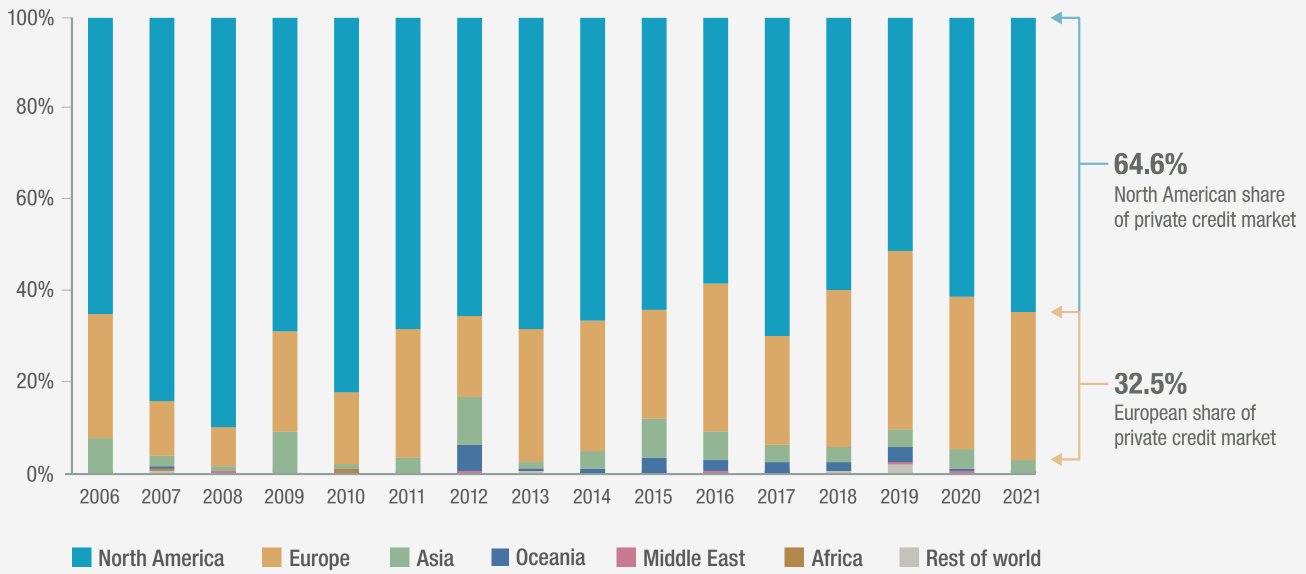
In our view, **private credit provides one of the most attractive ways for investors to harvest yield**. Many countries are experiencing negative real yields on government debt, and even as interest rates rise, the absolute level of government bond yields is likely to remain anemic. Private credit provides investors with the opportunity for higher risk-adjusted return potential and a diversification of credit exposure.

In addition, we believe that **including both U.S. and European private credit exposure** in a global portfolio may allow investors to leverage the regions differing historical backdrops and funding environments. The U.S. is a large, mature, and fairly homogeneous structure, while the European market is more fragmented, with documentation, origination strategy, and banking structure varying by country. Together, these markets may offer opportunities for private credit partners who can navigate the respective challenges and opportunities of their regions.

North American and European private credit comprise the majority of capital raised

Private debt capital raised by region



Source: PitchBook, 12/31/21.

However, as the themes of this paper outline, there is no risk-free investment. Allocators concerned about macro risks should consider the following factors when choosing an investment partner:

- **Exceptional credit evaluation** is key in accessing the best companies and limiting risks.
- **Diversification of borrowers** across industries helps build portfolio resiliency.
- **Strong partnerships**, backed by a long track record in the market, provide access to the best deals and transparency into borrowers' business operations. In our view, transparency provides meaningful value in managing risk.
- **Patient capital and a long investment time horizon** permit investors to turn down unattractive deals, maintain a strong pipeline, and build enterprise value over economic cycles.

DEFINITIONS

The **10-year Treasury note** is a debt obligation issued by the United States government with a maturity of 10 years upon initial issuance. A 10-year Treasury note pays interest at a fixed rate once every six months and pays the face value to the holder at maturity.

The **10-year Bund** is a debt obligation issued by the German government with a maturity of 10 years upon initial issuance.

The **Bloomberg Euro Aggregate Bond Index** includes fixed-rate, investment-grade Euro-denominated bonds. Investors frequently use the index as a stand-in for measuring the performance of the European bond market.

The **Bloomberg U.S. Aggregate Bond Index** is a broad-based, market capitalization-weighted bond market index representing intermediate-term investment grade bonds traded in the United States. Investors frequently use the index as a stand-in for measuring the performance of the U.S. bond market.

Broadly syndicated loans are floating rate loans made to corporate borrowers that generally have greater than $50 million in EBITDA (in most cases, at least $100 million). They are senior in the capital structure and have a first claim on the assets of the borrower.

The **Euro Interbank Offered Rate (Euribor)** is based on the interest rates at which a panel of European banks borrows funds from one another.

The **federal funds rate** is an interest rate at which depository institutions trade federal funds (balances held at Federal Reserve Banks) with each other overnight. It is the U.S. Federal Reserve's primary policy interest rate.

The **London Inter-Bank Offered Rate (LIBOR)** is a benchmark interest rate at which major global banks lend to one another. The **Secured Overnight Financing Rate (SOFR)** is a broad measure of the cost of borrowing cash overnight collateralized by Treasury securities. A LIBOR or SOFR floor is a provision in a loan agreement that establishes a minimum base floating rate to be paid by the borrower before the fixed spread.

A **"middle market" loan** is a loan made to an issuer of a certain size in the leveraged loan market. There are many definitions of this size, but in the research references, Standard & Poor's uses a $50 million threshold, meaning loans made to issuers with no more than $50 million of earnings before interest, tax, depreciation, and amortization (EBITDA), in its reports and statistics.

S&P Global LCD Quarterly Average All-in Spread of B+/B Institutional Loans is a benchmark metric for the return performance of institutional loans rated B/B+ including all fees, interest, and charges from the transaction.

The **S&P U.S. High Yield Corporate Bond Index** is designed to track the performance of U.S. dollar-denominated, high-yield corporate bonds issued by companies whose country of risk uses official G-10 currencies, excluding those countries that are members of the United Nations Eastern European Group (EEG). Qualifying securities must have a below-investment-grade rating (based on the lowest of S&P Global Ratings, Moody's, and Fitch) and maturities of one or more months.

Spread per unit of leverage (SPL) is defined as the ratio of potential return (spread) that an investor might receive per unit of risk (leverage). The higher the SPL, the better the compensation for the investor, holding risk constant.

A **"U.S. Single-B Corporate Debt Index"** is meant to designate a benchmark for corporate bonds rated B1/B+, one of several non-investment grade credit ratings that may be assigned to a company, fixed-income security, or floating-rate loan. This rating signifies that the issuer is relatively risky, with a higher than average chance of default.

1. Active management typically involves higher fees than passive management.

2. Source: S&P Global Market Intelligence, as of 12/31/21.

For more information

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Diversification cannot assure a profit or protect against a loss in a declining market.

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