Private Credit

IS NOW THE TIME TO INVEST?

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Chief Investment Officers

Today, more than ever, investors should consider making a strategic allocation to private credit. As traditional institutions pull back from lending in the current environment, cash-strapped borrowers are increasingly seeking private credit funding. This has enabled private credit lenders to negotiate more favorable lending terms and higher absolute yields. As a result, the risk-adjusted return potential for private credit is stronger today than it has been in a decade.

What is Private Credit?

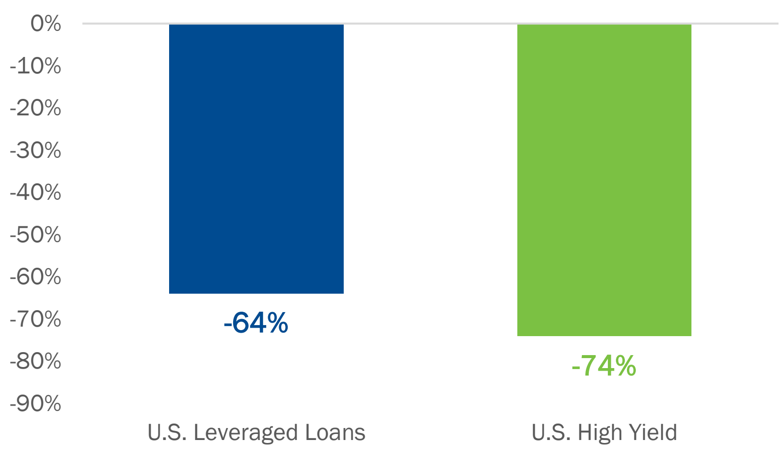
At the most basic level, private credit is any privately negotiated loan made outside the public debt markets. Private credit often refers to direct lending to small or medium-sized companies that don't have ready access to bank financing and businesses that need funds quickly, but it also includes mezzanine financing, real estate loans, "special situations" and other niche, specialized credit strategies. For more information on private credit, see our white paper entitled *The Case for Private Credit.*

Why Now?

While we believe private credit plays an important role in a diversified portfolio, the opportunity is particularly compelling today.

The Public Credit Markets Have Dried Up - Issuance across the U.S. leveraged loan and high yield bond markets ground to a halt by the end of 2022. Reacting to stubbornly high inflation and rising interest rates, investors have pulled capital from liquid credit strategies favoring safe-haven assets such as U.S. Treasurys. This risk aversion has thwarted the new-issue market, stifling refinancing opportunities and stranding banks with loans they are unable to syndicate. As a result, banks have restricted their corporate and wholesale lending. With public and leveraged loan markets essentially closed for new issues, all new financing activity has migrated to the private capital market.

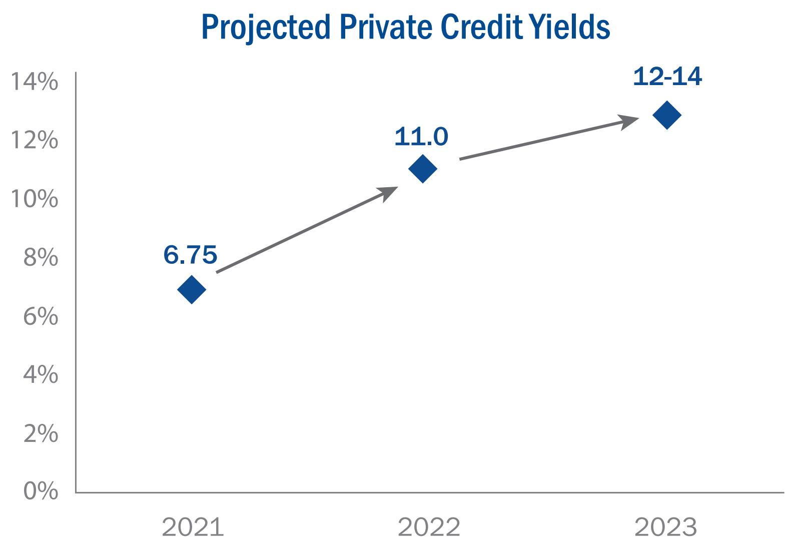
2022 vs 2021: % Change in Issuance Volume



Source: Bloomberg, Hirtle Callaghan. As of December 31, 2022.

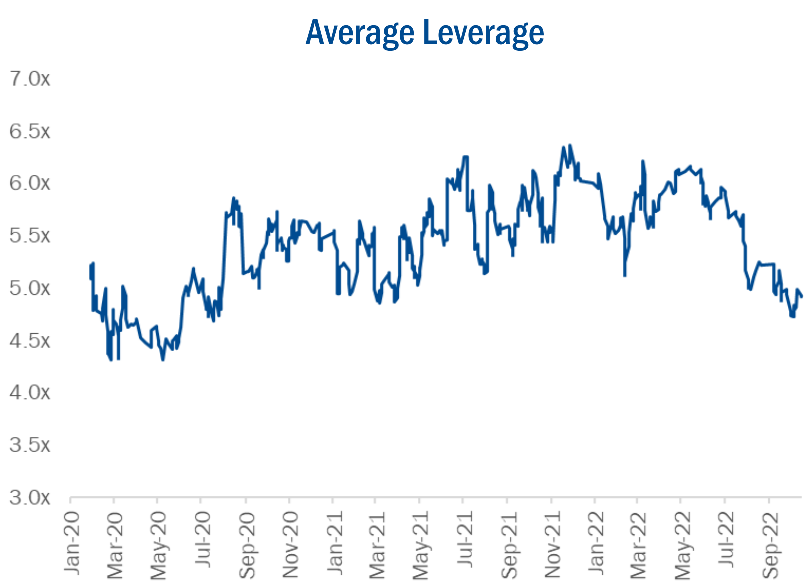
Private Credit Opportunity Set Is Larger and Higher Quality - Because public credit issuance has stalled, private credit is the only game in town for companies looking to raise capital. As such, it is attracting larger, more established companies than it has in the past. These borrowers have the operating models and cash flows to weather the current supply chain and inflation headwinds. They have supplanted less established companies who have historically been more likely to borrow in the private market. In general, businesses that are negatively impacted by the current environment are not transacting today.

Private Credit Pricing and Deal Terms Are More Favorable - The current dynamics have led to more attractive deal pricing and lender-friendly terms. Compared to a year ago, pricing has increased by as much as 50 to 100 basis points. We believe 10%+ yields are achievable for senior secured loans with leading private equity sponsors who are contributing significant equity to the transactions.



Source: Apollo Global Management.

Leverage Levels Are Lower - Higher interest costs are causing companies to rethink their ability to service debt payments. As a result, leverage levels are declining which provides lenders with a greater margin of safety.



Source: KKR proprietary database of screened deals. For more inflation, read KKR's report "Regime Change: The Benefits of Private Credit in the 'Traditional' Portfolio."https://www.kkr.com/global-perspectives/publications/regime-change-benefits-private-credit-traditional-portfolio

Floating Rate Debt Provides Inflation Protection - Private credit is particularly well suited to navigate the current inflationary and rising rate environment. Transactions are typically tied to floating rates (such as SOFR). When interest rates rise, those increases are automatically reflected in the private credit yields. This dynamic makes floating-rate debt less sensitive to interest rates compared to fixed-rate bonds, which typically lose value as interest rates rise.

Transactions are Structured with Downside Protection - Because private credit borrowers typically do not have access to the traditional sources of capital, private credit lenders tend to have greater influence over loan structuring. Terms typically provide stronger covenant packages, more frequent and transparent financial reporting, and higher amortization payments than those found in public debt. They can also include structured equity, high prepayment penalties and a role in the oversight or management of the company. Combined, these features help to ensure greater capital preservation, lower default rates and an alignment of interests between the borrower and lender, which is particularly meaningful in volatile or recessionary environments.

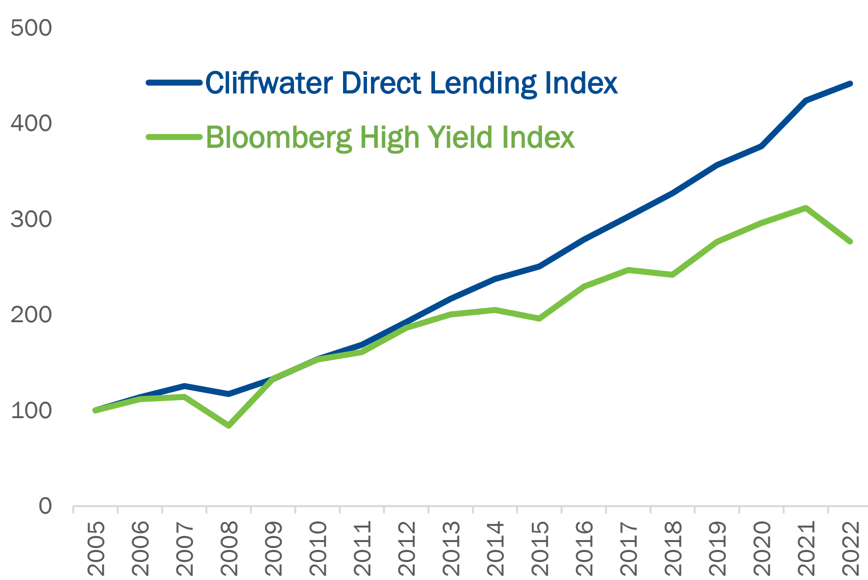
Private Credit Plays an Important Role in a Diversified Portfolio

While now is a particularly compelling time to invest in private credit, we believe the asset class plays an important role in a diversified portfolio over the long term. Private Credit complements traditional fixed income strategies, as it provides incremental income, total return enhancement and portfolio diversification.

Income Generation - Private credit typically offers higher income than the high yield or syndicated leveraged loans markets. Because its borrowers are often in unique situations that prevent them from accessing traditional markets, they are willing to pay a premium for the certainty of execution, agility and customization that private lenders offer.

Total Return Enhancement - By taking on illiquidity, private credit investors can typically access higher and more reliable income streams, priced above traditional fixed income. Private credit returns tend to be less volatile, as investments are not as readily marked-to-market. Over the last 15+ years, private credit has outperformed public credit by a wide margin.

Direct Lending vs. High Yield Cumulative Returns 2005-2022 (Indexed at 100)



Source: Bloomberg, Hirtle Callaghan. As of February 14, 2022. The Cliffwater Direct Lending Index is an asset-weighted index of 11,884 directly originated middle market loans totaling $264 billion as of September 30, 2022.

Diversification - An allocation to private credit adds to the overall breadth of a diversified portfolio beyond equities and traditional fixed income. It includes a broad array of strategies including corporate credit, hard assets, soft assets, consumer credit and commercial real estate.

What Are the Risks?

Despite the many benefits to private credit, there are also inherent risks. One of the most significant drawbacks is the lack of liquidity. Private credit investors must be willing to wait until their investments reach maturity, as these instruments are less liquid than broadly syndicated leveraged loans. Moreover, private credit borrowers have historically been smaller and had weaker credit profiles than companies that can access the public markets (although, as we have pointed out, that is not the case in today's market). These borrowers will likely come under pressure should the economy experience a recession.

We take comfort in the fact that many private credit opportunities are direct loans to private equity-owned companies. The presence of a sponsor acts as a risk mitigant because they have conducted extensive due diligence and invested significant capital in the company. Private credit positions are typically at the top of the capital structure which puts them in a very strong position. In addition, because transactions typically involve bilateral negotiations between a single lender and a borrower, the terms are structured to create alignment between the two parties. This can lead to more efficient workouts and greater recovery in the event of a default compared to publicly syndicated debt that involves multiple lenders with competing priorities.

While we believe private credit always plays an important role in a diversified portfolio, the risk-adjusted return potential for private credit is stronger today than it has been in a long time. In the current inflationary, rising interest rate environment, private credit provides an opportunity to navigate and capitalize on the challenges ahead.

Hirtle Callaghan was founded in 1988 as America's First Outsourced Chief Investment Officer™ for institutions and families. Serving as an independent investment office has been our only line of business for over 30 years. As CIO, we offer objective investment advice to investors seeking to improve the structure, process and returns of their investment programs. Today, we are a national firm known for its professional, client-centric culture. With each client in mind, we design and manage a complete, custom-designed investment program that is diversified across global opportunities, including public and private markets. For more information about Hirtle Callaghan, please visit www.hirtlecallaghan.com.