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PRIVATE CREDIT: A GROWING ALTERNATIVE TO TRADITIONAL LENDING

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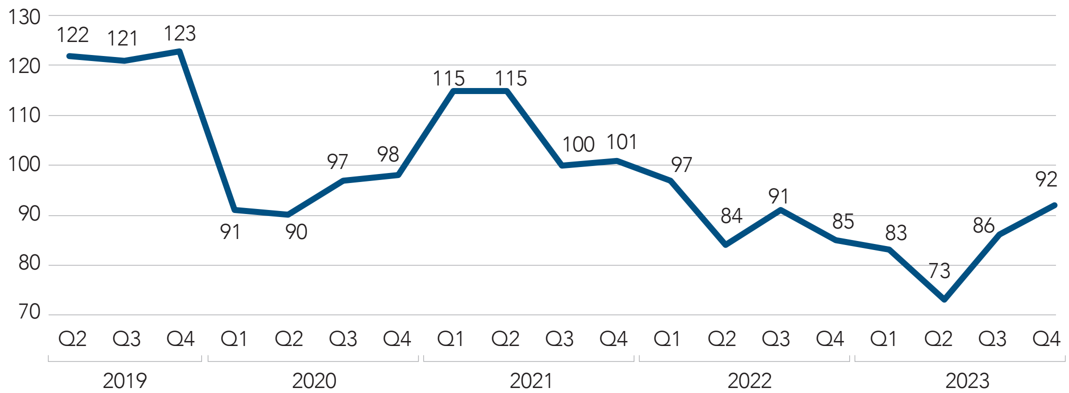
As banks become more stringent with their loan policies, private credit is providing companies with greatly needed capital and investors with great potential investment opportunities.

Amidst the Federal Reserve's recent aggressive monetary policy tightening cycle, characterized by eleven consecutive interest rate hikes, traditional lenders have adopted a cautious stance.

Banks have become more conservative with their underwriting standards and exhibited declining economic optimism, as evidenced by the Community Bank Sentiment (CSBS) Index, which has remained negative for eight consecutive quarters.

CSBS COMMUNITY BANK SENTIMENT INDEX[1]



Sentiment Index (100= Neutral; >100 Positive; <100 Negative)

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Similarly, as of January 2024, 14.5% of banks reported tightening standards for commercial and industrial (C&I) loans for large and medium businesses, and 18.6% reported tighter standards for small businesses. This follows a December in which banks reported tighter standards for 33.9% of large and medium businesses and 30.4% for small businesses.[2]

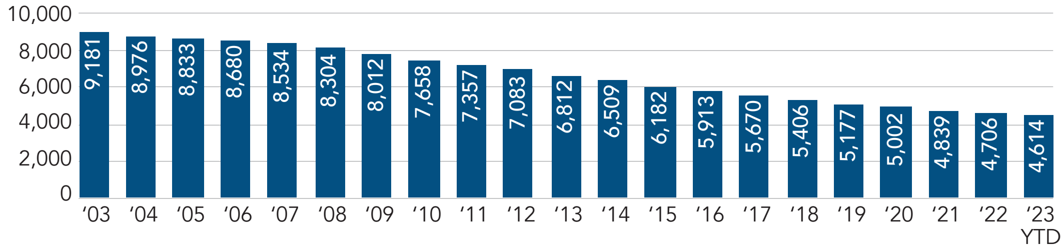
30.6% of banks also increased the cost of credit lines for large and medium firms, while 34.5% reported increasing the cost of credit lines for small businesses. This comes after an aggressive December 2023 in which 50% of banks reported an increase for large and medium businesses and 44.6% reported an increase for small businesses.[2]

1. The Community Bank Sentiment Index is an index derived from quarterly polling of community bankers across the nation. As community bankers answer questions about their outlook on the economy, their answers are analyzed and compiled into a single number. An index reading of 100 indicates a neutral sentiment, while anything above 100 indicates a positive sentiment, and anything below 100 indicates negative sentiment.
2. Large and medium businesses are defined as firms with annual sales of $50 million or more. Small businesses are defined as firms with less than $50 million in sales. "Senior Loan Officer Opinion on Survey on Bank Lending Practices." The Federal Reserve. https://www.federalreserve.gov/data/sloos/sloos-202401-chart-data.html

In addition to the more conservative lending environment, the banking industry has experienced ongoing consolidation. In 2003, the landscape boasted over 9,000 FDIC-insured banks, a figure which fell to just over 4,600 by September 2023. Despite this contraction, total assets have continued to increase, growing from $9.1 trillion in 2003 to $23.4 trillion in September 2023.[3]

FDIC-INSURED HISTORICAL TRENDS[3]

As of September 30, 2023



As banks fall away and more become apprehensive about lending, privately held businesses still require access to capital. This apprehension in the traditional lending landscape presents potential opportunities for private credit and its investors, who may be able to take advantage of such benefits as enhanced income potential, diversification, and exposure to private companies not available in the public credit markets.

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WHAT IS PRIVATE CREDIT?

Private credit refers to a form of lending beyond the confines of conventional banking channels. With private credit, lenders and borrowers work directly to negotiate and originate loans that may be untraded in the public markets.

Private lenders address borrower demand by providing tailored financing solutions characterized by flexibility, expedited execution timelines, and greater certainty of closing that traditional banks often cannot match, particularly in challenging market conditions. Between 2019 and 2022, for example, private credit funds provided roughly 49% of the debt financing for leveraged buyouts in excess of $1 billion.[4]

While private credit has recently grown to include loans to larger firms, it traditionally has catered to the needs of small and middle-market companies, which may often be underserved by traditional channels due to regulatory constraints, inflexible offerings and/or timely underwriting and funding. Approximately 70% of companies "too small for bank syndication" rely on private credit.[5]

EQUIPMENT FINANCE: A UNIQUE OPPORTUNITY FOR PRIVATE CREDIT

One such area where private credit may support small or middle-size businesses is the vast $1 trillion equipment financing sector.[6] Nearly 80% of businesses leverage this crucial solution to acquire essential equipment without substantial upfront costs, underlining its critical role in business growth and productivity.[6]

Fueled by a consistent focus on modernizing operations, a 2.2% increase in real equipment and software investment is expected in 2024.[6] Industrial automation is expected to see an 8% global surge this decade, with industries like logistics, retail, and manufacturing leading investment in robotics and automation adoption.[6] Similarly, Artificial Intelligence ("AI") utilization is poised for growth, particularly in marketing and technology sectors.

Additionally, equipment types such as construction machinery, computers, software, and aircraft are strongly positioned to thrive, despite elevated interest rates.[6] Climate focused projects and technology should also grow as more businesses prioritize sustainability and environmentally friendly manufacturing solutions.

3. As of September 30, 2023. "FDIC Statistics at a Glance." FDIC. https://www.fdic.gov/analysis/quarterly-banking-profile/statistics-at-a-glance/2023sep/fdic.pdf
4. Panossian. Armen. "Guest View: Direct Lending May Be Entering a New Era." Reuters. April 13, 2023. https://www.reuters.com/breakingviews/guest-view-direct-lending-may-be-entering-new-era-2023-04-13/
5. "Economic Contribution of Private Credit to the U.S. Economy in 2022." Prepared for the American Investment Council by Ernst & Young. October 2023. https://www.investmentcouncil.org/wp-content/uploads/2023/10/EY-AIC-Private-credit-attributed-employment-report-09-28-2023-1.pdf
6. "Toolkit: Top 10 Equipment Acquisition Trends for 2024." Equipment Leasing and Finance Association. 2024. https://www.equipmentfinanceadvantage.org/toolkit/10trends.cfm

This year, 54% of equipment acquisitions are expected to be financed and, with the decreasing number of banks and overall stricter lending standards, more of these acquisitions may be financed by private credit.[6]

Equipment financing and leasing may also provide its own set of advantages. As with many forms of private credit, it may offer the opportunity for consistent cash flow through fixed lease payments, but it also has a low correlation to traditional equity and debt markets and has demonstrated its ability to withstand large shifts in both.[7] Operating leases may also generate significant depreciation, which may translate into certain tax advantages, such as passive non-cash losses which may be used to offset passive gains.

Furthermore, equipment leases can also provide lessors with a purchase money security interest (PMSI), meaning the lessor legally owns the equipment. This grants the lessor legal ownership of the equipment, contrasting with the weaker position of a lien held by a lender in a loan agreement. This elevated legal standing offers greater security and potential recovery options in case of default.

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A COMPELLING ASSET CLASS WITH INHERENT POTENTIAL ADVANTAGES

Private credit may offer opportunities for potentially higher yields compared to traditional fixed-income strategies, along with several potential benefits, including:

CURRENT INCOME: Similar to traditional fixed income, private credit generally offers the possibility for current income through contractual interest payments and fees.

ILLIQUIDITY PREMIUM: Private credit may compensate investors for the limited liquidity of private credit instruments, often resulting in higher yields compared to publicly traded corporate bonds.

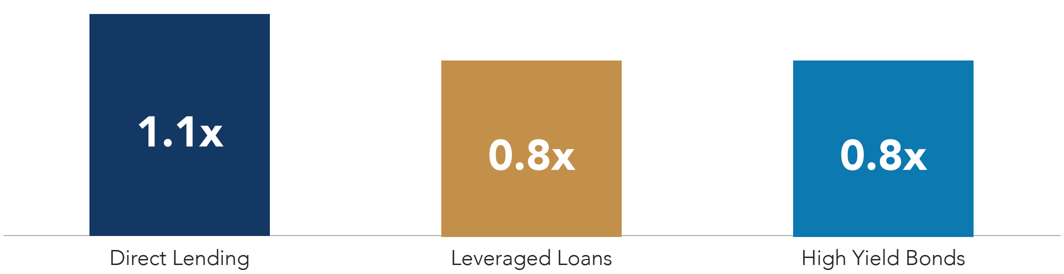
HISTORICALLY LOWER LOSS RATES: Private credit has exhibited lower default rates over time compared to public credit, contributing to improved portfolio stability.

DIVERSIFICATION: Due to its historically low correlation with public markets like equities and bonds, private credit can enhance portfolio diversification and potentially deliver more resilient risk-adjusted returns.

CUSTOMIZED PORTFOLIO CONSTRUCTION: Investors may be able to construct targeted portfolios by blending various private credit strategies based on desired risk-adjusted return profiles.

Private credit has historically offered compelling performance in relation to other segments of the fixed-income market. For example, direct lending, the most common type of private credit, has also historically outperformed both leveraged loans and high-yield bonds, providing higher returns and lower volatility.

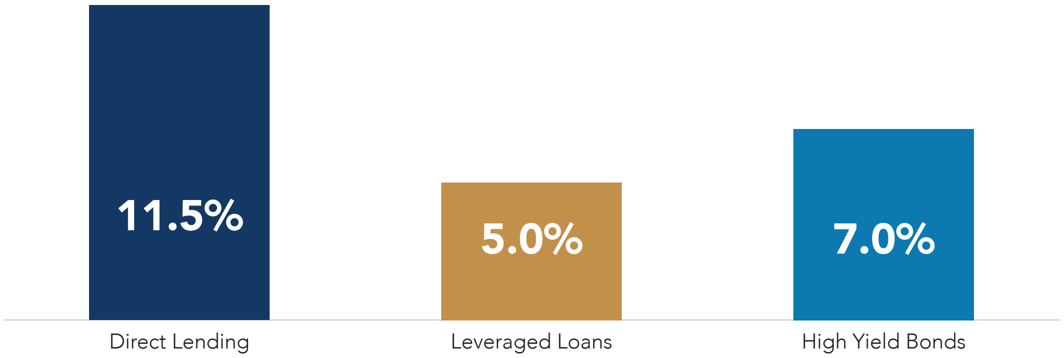
HIGH RETURNS RELATIVE TO VOLATILITY[8]
(2008 – Q2 2022)



7. Kamradt, Jason. "How to Invest in Equipment Leasing." Real Assets Adviser. March 1, 2018. https://irei.com/publications/article/invest-equipment-leasing/
8. Data represents the period from Q1 2008 to Q2 2022. Calculated as annualized average returns divided by volatility. Volatility is measured using standard deviation. "Direct Lending" is represented by the Cliffwater Direct Lending Index (CDLI) and is calculated from quarterly data, which has been annualized. "High Yield Bonds" is represented by the ICE BofA High Yield Index calculated from annualized monthly data, except for the loss experience chart, where this is sourced from Moody's. "Leveraged Loans" is represented by the Morningstar LSTA US Leveraged Loan Index calculated from annualized monthly data, except for the loss experience chart, where this is sourced from Moody's.

DIRECT LENDING'S OUTPERFORMANCE IN HIGH INTEREST RATE ENVIRONMENTS[9]

(2008 – Q2 2022)



MANAGEMENT MATTERS

Of the $11.3 trillion global alternative asset market, about $1.3 trillion, or 12% is in the private credit space, and growth is expected to continue within the global private credit market, with estimates reaching $2.3 trillion by 2027.[10]

While the size, expected growth, and potential advantages of the private credit market may make it an attractive prospect, investor success may often hinge on meticulous manager selection. Given the reliance on sponsor-driven deal flow in many private credit strategies, experienced managers with longstanding sponsor relationships may hold a significant edge over newer entrants. This stems from their ability to navigate complex transactions effectively and offer certainty of execution, a crucial differentiator in a competitive environment.

Private lenders compete not just on price, but also on speed and execution assurance. Seasoned managers, armed with robust networks, deep sector expertise, and operational scale, may often have the ability to secure deals even without offering the lowest price. Their ability to guarantee timely closings at the negotiated yield is particularly valuable in today's volatile market, allowing them to command premium pricing for their loans.

Private credit is poised for continued expansion, capitalizing on the void left by traditional lenders. For investors, it presents a compelling asset class, offering the potential for stable income generation, enhanced yields relative to corporate bonds, diversification benefits through lower volatility and reduced correlation with broader fixed-income indices, and exclusive access to private companies not found in public credit markets.

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9. Data represents the period from Q1 2008 to Q2 2022. Calculated as annualized average returns divided by volatility. Volatility is measured using standard deviation. Represents average returns during 6 time periods (1Q'09-2Q'09, 4Q'10-1Q'11, 4Q'12-4Q'13, 3Q'16-4Q'16, 3Q'20-1Q'21, and 3Q'21-2Q'22) when rates increased by 75bps+.
10. As of June 2022 (most recent data available). "The Growth of Direct Lending." BlackRock. February 2023. https://www.blackrock.com/institutions/en-us/literature/market-commentary/direct-lending-qa-feb-2023.pdf

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