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Private Credit Primer

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Executive Summary

- Private credit refers to debt, or debt-like, securities that are not publicly issued or traded and are
- Private credit has a variety of strategies that include direct lending, distressed debt, venture debt, mezzanine finance, and special situations.
- Direct lending is the largest segment and accounts for about 40% of the U.S. private credit market.
- The largest investors in private credit are typically pension funds, insurance companies, and sovereign wealth funds
- As the private credit market scales up to a larger and broader base of investments, its historical performance may not translate to comparable performance in the future.
- Private credit has recently evolved from the more traditional issuer obligation transactions to more complicated structured finance type structures.
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Private credit is an evolving, alternative funding source. In recent times, rather than obtaining funding through broadly syndicated loans (BSLs), an increasing proportion of middle-market funding has come from private credit. It has also grown from mostly being utilized by middle-market firms to now also serving as a funding source for larger companies that had primarily utilized BSLs and the high-yield bond market for capital financing. In addition, private credit has evolved into many types of assets, such as infrastructure projects, real estate, and asset-based lending.

Although the inception of private credit dates back to the 1980s, when insurance companies served as direct lenders to companies with strong historical borrowing standards, private credit gained broader popularity after the 2008 financial crisis. At that time, private credit represented an alternative to traditional bank lending, as regulators began imposing lending restrictions on certain financial institutions. Over time, private credit has become a competitor to traditional bank lending for all types of businesses. This includes expanding into asset-based financing, which historically has been a product of bank lending, where loans are secured by collateral, such as inventory, receivables, equipment, or property.

What is Private Credit?

Private credit refers to debt, or debt-like, securities that are not publicly issued or traded. Non-bank lenders, including insurance companies, private debt funds, and business development companies, issue private loans directly to mostly small and middle-market companies that do not have—or have limited—access to the public corporate bond and loan markets. These small and middle-market companies often have more debt than larger companies that access capital via leveraged loans and public bonds and, therefore, they are more susceptible to economic downturns and the impact of rising interest rates.

The direct nature of the transaction allows for terms and conditions to be negotiated to meet the specific needs and objectives of the individual borrower as well as the lender. Private credit lenders benefit from stronger control over documentation and are able to derive customized terms and more flexible solutions. Working directly with borrowers generally results in faster and greater execution

Graph 1:

For investors, an allocation to private debt and ensuing diversification can result in protection from general market volatility. Private debt typically prices at a floating rate, which benefits investors in a high interest rate environment.

On the other hand, private credit can create potential risks. The lack of liquidity limits investors' ability to trade private debt securities if desired, as there is a limited secondary market. As a result, valuation tends to be infrequent, and credit quality is not always easy to ascertain. However, in the event of stress, lenders and investors should be able to work directly with the borrower to modify the transaction terms or add investor safeguards. In addition, there is little to no transparency in private credit transactions for market participants who are not directly involved. It can, therefore, be challenging for outside investors and other market participants to determine and price risk. Because of minimal regulation and the opaque nature, or lack of transparency, with private credit lending, the U.S. Securities and Exchange Commission (SEC) established a rule requiring private credit fund managers to disclose more information regarding fees and certain activities.

Private credit lenders have been able to grow their investor base and diversify lending across various investor types. The largest investors in private credit typically include pension funds, insurance companies, and sovereign wealth funds, but many other types of in-0.8 (d)-0.7 5MC ET r6522.5 9203.28 445.2 1

Depending on the definitional source, private credit is considered to have a variety of strategies. According to Preqin, there are five key strategies for private credit[1]:

1. : Companies borrow directly from a non-bank lender acting alone or as part of a small group. The lender typically holds the loans to maturity
2. : Private credit funds buy corporate debt trading significantly below its original value or provide new financing to a distressed company, hoping to turn a profit as the business

attractive features to borrowers such as faster execution and greater pricing certainty. Some of these lenders have included alternative asset managers