SPECIALTY FINANCE

Understanding Private Credit

October 2023 | CMG Capital Management Group, Inc.

When a company requires debt financing for various purposes such as sustaining its daily operations, expanding its business, or making corporate acquisitions, it has several options to consider. One commonly chosen avenue is securing a loan from a bank. Larger corporations may opt to issue bonds or equity that are subsequently traded in the public financial markets. Another viable option is private credit, where the company partners with a single lender to develop a custom-tailored capital solution.

At certain points in the economic cycle, banks may be less willing to lend. This creates additional opportunities for private credit lenders. Some businesses may need capital quickly, especially in more challenging economic cycles, and need funding sources that can move quickly.

Private credit offers several advantages for borrowers. It provides a high level of certainty and expedites the execution process. Lenders require sufficient collateral to back the loan and may add loan origination and exit fees, to enhance the return for the risk being taken.

For a borrower, private credit funds offer the ability to quickly secure funding and for investors a compelling investment opportunity providing income, collateral protection, risk mitigation, and portfolio diversification. This paper provides a summary of various types of private credit investments.

Why Private Credit?

- An attractive feature of private credit instruments is that loans are **linked to floating rates**, such as SOFR (Secured Overnight Financing Rate). Private credit loans are typically made at SOFR which was 5.3% in October 2023, plus an additional yield of 4% to 10%. For example, currently borrowers pay, and the private

credit funds who lend to them earn between 9% to 15%. If SOFR rises, the lending rate increases and, if SOFR falls, the lending rate falls.

- This feature makes **the floating-rate debt less susceptible to interest rate changes** and an attractive investment alternative for investors.
- **Private credit has outperformed traditional bonds over nearly two decades**. From January 2005 through September 2023, the Cliffwater Direct Lending Index had an annualized return of 9.2%. Over the same period, the Bloomberg U.S. Aggregate Bond Index had an annualized return of 2.8% and the Bloomberg US Corporate High Yield Bond Index had an annualized return of 6.1%.

Why Now?

The world is structurally different than it has been over the last 40 years. We call the structural change, *"The Great Reset,"* a phrase coined by our Chief Economist John Mauldin and initially discussed here.

The current set of conditions (record debt levels, higher interest rates and higher inflation) are not new to the world, but they are new to most investors alive today. They are challenges that typically present themselves at the end of long-term debt accumulation cycles.

Historically, long-term debt cycles last 75-100 years. For the United States, the last cycle peaked in the 1930s. The governments saw money creation as the best solution and the economic consequence of their fiscal misbehaviors were periods of high inflation and low growth. How it gets resolved this time around remains unknown, but evidence suggests we may be headed down a similar path.

Think of the *Great Reset* as a debt restructuring. Corporations restructure all the time. Existing investors see their asset values marked down, which can lead to opportunities for patient investors sitting with liquidity.

History shows that, in most instances, governments have chosen to print or inflate their way out of the mess. When governments create too much new money, challenges mount.

Too much money chasing too few goods causes inflation. The U.S. and much of the developed world, with similar debt and entitlement challenges, will likely choose to print new money to solve the debt mess they have created.

Not surprisingly, this has happened in the U.S. and much of the developed world since 2008 and more significantly since 2020. In the U.S., nearly half of all the dollars ever created were printed in the last few years. It took more than 246 years to print $10 trillion. Since 2020, an additional $10 trillion has been created. The inflation we are experiencing should not come as a surprise.

The ***Great Reset* is a slow-moving event** and we believe it will crescendo when it reaches a point where, like in the Road Runner Cartoon, when Wylie Coyote finds himself out over the cliff edge. Then, everyone knows that what we've been doing did not work and a forced restructuring must take place.

The winds have shifted, and the benefit of nearly 40 years of declining interest rates is gone. Due to the accumulation of massive debt and entitlement obligations, probabilities favor a prolonged period of higher inflation, higher interest rates and slower growth.

The Advantages of Short-term Private Credit Funds

Short-term private credit funds offer a compelling investment opportunity with several advantages for investors seeking income generation, collateral protection, risk mitigation, and portfolio diversification.

Firstly, short-term private credit funds typically focus on **lending to small and medium-sized enterprises** (SMEs) and other non-traditional borrowers. This presents an opportunity to earn higher yields compared to traditional fixed-income investments like government or corporate bonds. The shorter duration of these loans means lenders can access their capital relatively quickly, providing liquidity advantages.

Secondly, short-term private credit funds are **less susceptible to interest rate fluctuations**. Loans are short-term with a floating interest rate structure, which mitigates

the impact of rising interest rates on portfolio values, reducing interest rate and inflation risks for investors.

Thirdly, these funds often correlate less **with traditional asset classes** like stocks and bonds. By adding short-term private credit funds to a diversified portfolio, investors can enhance risk-adjusted returns and reduce overall portfolio volatility. Furthermore, investing in short-term private credit funds may offer an **element of downside protection**. These funds typically prioritize senior secured loans or collateralized debt, which can provide a degree of protection in case of borrower defaults.

Lastly, the private nature of these funds means they tend to be less susceptible to **market sentiment. Active management** allows fund managers to respond swiftly to changing economic conditions and credit risk, potentially enhancing returns.

Diversification is a crucial consideration in the realm of private credit. Various private credit strategies exhibit differing levels of exposure to the overall well-being of the economy, which impacts the well-being of corporate borrowers, consumers, and real assets. For instance, corporate and real assets often track closely with the ups and downs of the economic cycle. In contrast, strategies like distressed and opportunistic credit may display more counter-cyclical tendencies, meaning they tend to identify more appealing opportunities during economic downturns. Some specialized credit strategies also show reduced sensitivity to the broader economic cycles.

Analyzing Private Credit

In private credit, the landscape is diverse, with each type of loan carrying its own distinct set of risks and potential returns. These returns can be broken down into two main components: yield and capital appreciation.

Let's explore the spectrum of private credit strategies:

1. **Senior, Secured Loans**: These loans are positioned at the safer end of the spectrum. They offer a relatively steady yield and are characterized by lower risk compared to other private credit strategies. They come with the advantage of being secured, reducing the likelihood of loss in the event of a default.
2. **Unsecured Subordinated and Mezzanine Strategies**: As we move further down the capital structure, we encounter higher-yielding opportunities. These strategies compensate investors for taking on additional credit risk. In some cases, these loans may also include additional securities that allow investors to participate in potential equity gains, adding an extra layer of potential return.
3. **Specialty and Alternative Credit Opportunities**: This category encompasses a wide range of opportunities, each with its unique risk-return profile. These opportunities often generate cash yield and can span the entire risk spectrum, offering options that cater to various investor preferences and risk tolerances.
4. **Distressed and Opportunistic Strategies**: At the far end of the spectrum are strategies that target companies facing significant challenges. These investments have the highest potential for dispersion of outcomes, making them the riskiest option. Unlike the others, these strategies typically lack a yield component but come with the prospect of substantial upside as the distressed companies undergo restructuring.

In summary, when delving into private credit investments, it's crucial to understand that **risk and return are intimately linked**. While it's difficult to mathematically analyze private credit in a portfolio due to the lack of marked-to-market returns (Sharpe ratios become irrelevant), we can gleam the portfolio benefits of private credit by looking at longer-term returns, identifying superior fund managers, and allocating to specific types of private credit strategies within the economic cycle.

Higher potential returns are often associated with increased risk, and we encourage investors to **carefully consider their risk tolerance and investment goals** when choosing among these various private credit strategies.

Current Market Backdrop Positive for Floating Rate Debt

As mentioned above, the Cliffwater Direct Lending Index returned an impressive 9.2% annualized since 2005, during a time of ultra-low interest rates. ZIRP, the Federal Reserve's zero-interest rate policy, was in effect for most of this period, keeping borrowing costs down and resulting in low base lending rates for private lenders.

Today, the Federal Funds Rate is over 5% and the base lending rate, SOFR, at 5.3%. **Add in the spread over SOFR lenders earn**, with current yields in the 10% to 15% range, it is easy to see the current market backdrop is more favorable for floating rate funds.

CMG believes the 40-year bull market in bonds (rates declining) is over. This secular (long-term) **interest rate shift gives a floating rate investment an inherent advantage.** Credit conditions are deteriorating, and **bank lending standards have tightened.** Small to mid-sized banks, in particular, are leveraged and capital constrained. Further, they are saddled with bad CRE (commercial real estate) loans, which reduces their capital structure, leaving them less able to take advantage of credit opportunities.

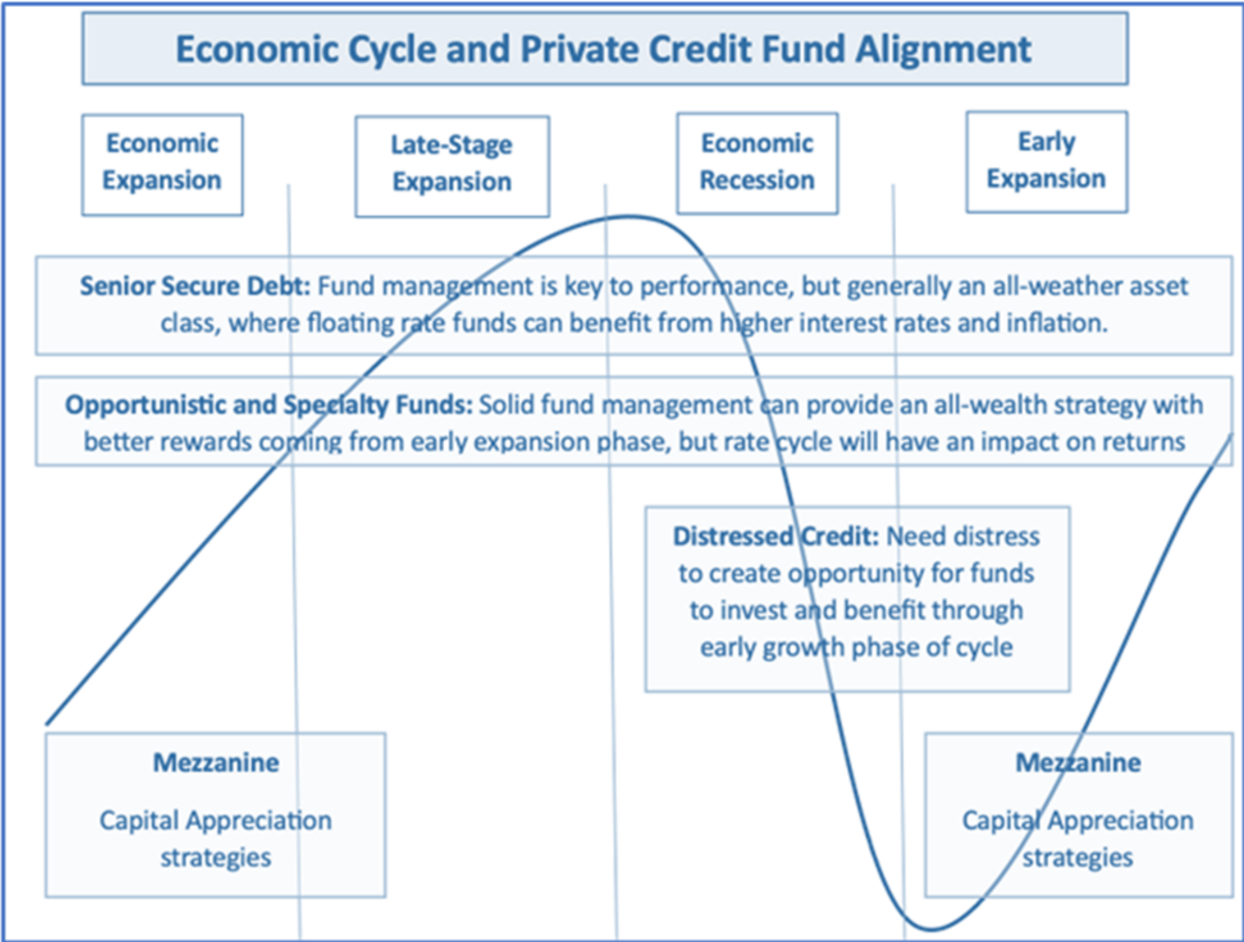
Many private credit funds are **bespoken in their lending operation**, providing the market with niche, custom lending frameworks. The private credit market is positioned to fill this gap.

Private credit is a broad category with various strategies, and the risk associated with those strategies can vary. They range from first lien senior secure loans to unsecured distressed credit.

The Private Credit Ecosystem

Not all private credit is the same. Diversification is an important consideration. The chart on the next page showing the major private credit fund types provides a general view of where various private credit strategies may benefit in the economic cycle.

Private credit funds encompass a wide range of investment strategies and structures, each designed to meet specific investor needs and risk profiles.



Source: Cambridge Associates, LLC

Types of Private Credit Funds

Direct Lending Funds

These funds lend money to businesses, typically middle-market or small and medium-sized enterprises (SMEs). They offer customized financing solutions with varying terms and structures. Most loans are made at SOFR plus a spread. For example, the current SOFR rate is 5.3% (October 1, 2023), and many, not all, loans are written with front-end origination and back-end maturity fees.

Mezzanine Debt Funds

Mezzanine debt funds provide subordinated loans with higher interest rates to companies needing capital. They often combine elements of debt and equity, offering greater potential returns and higher risk.

Special Situations Funds

These funds focus on unique or opportunistic credit situations, such as lending to niche business where the manager has a special understanding of the underlying collateral (royalties for example), trade financing, credit protection insurance, financing for mergers and acquisitions, recapitalizations, or other specific corporate events.

Real Estate Debt Funds

Real estate debt funds provide loans for projects, including commercial properties, residential developments, and infrastructure. These funds can target various stages of the real estate lifecycle, from construction to bridge financing.

Structured Credit Funds

Structured credit funds invest in complex credit instruments like collateralized loan obligations (CLOs), collateralized debt obligations (CDOs), and asset-backed securities (ABS). These funds often involve more sophisticated strategies and may have exposure to a wide array of underlying assets.

Private Equity Funds with Credit Strategies

Some private equity funds incorporate credit strategies alongside their equity investments. They may offer a combination of equity, mezzanine, or senior debt investments within a single fund.

Senior Secured Debt Funds

These funds primarily invest in senior secured loans with a higher claim on a company's assets in the event of default. They tend to have a lower risk compared to subordinated debt or equity; thus, they typically are considered an all-weather strategy since these debt

holders have a superior rank of repayment if there are any company finance issues. The cash yield drives the returns, thus investors[RS1] interested in income might consider these types of funds.

Venture Debt Funds

Venture debt funds provide debt financing to early-stage or high-growth startups. This type of private credit aims to support companies needing capital but may not yet be profitable.

Credit Opportunities Funds

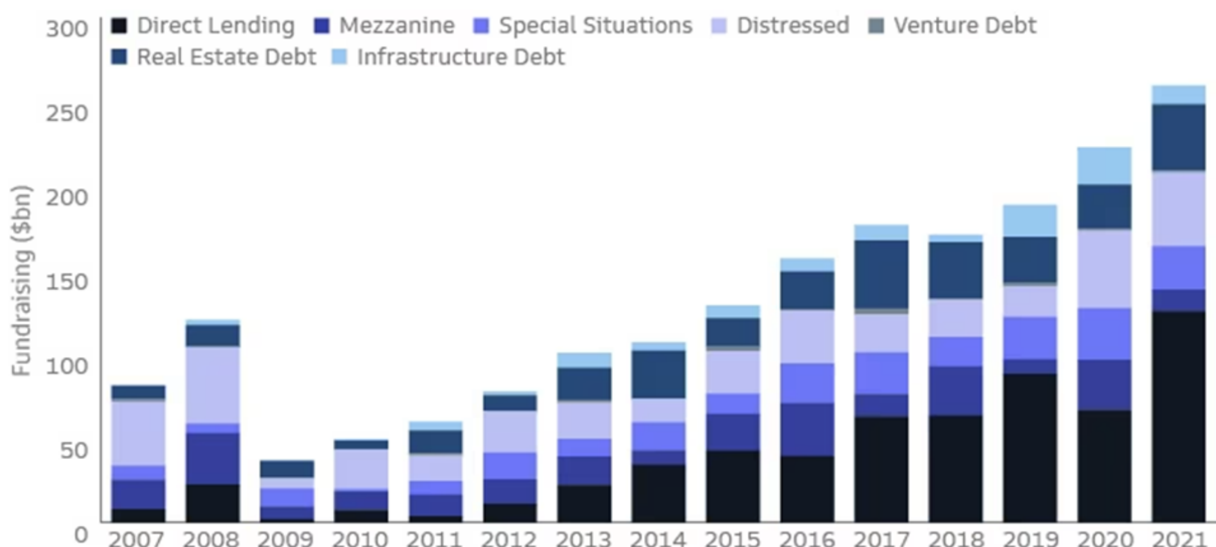
Credit opportunity funds have flexible mandates to pursue a wide range of credit investments. They may shift their focus based on market conditions and available opportunities.

Business Development Companies (BDCs)

BDCs are publicly traded investment companies that finance small and mid-sized businesses. They often take the form of closed-end funds and must distribute at least 90% of their taxable income to shareholders.

Each type of private credit fund has its risk-return profile, investment horizon, and target borrowers. Investors should carefully consider their investment objectives, risk tolerance, and the specific strategy of the fund before investing in private credit funds. Additionally, due diligence and understanding the fund manager's expertise are crucial when selecting a private credit fund that aligns with one's investment goals.

At the current part of the cycle, CMG favors first-lien, senior secure, floating-rate debt. We like short-term specialty finance funds. We think investors should consider these allocations for a core or anchor position in an investment portfolio, providing attractive income opportunity and portfolio protection in a tightening credit cycle. We favor these types of strategies over low yielding government, municipal and corporate bonds, and bond funds. For certain investors, we also encourage a close look at distressed credit funds as we anticipate opportunities in the default cycle that we believe will present in the next recession.



The above chart is from an excellent Goldman Sachs paper on Private Credit. You can find the full article here.

Risk Drivers and Due Diligence

There is risk in all investing, and the objective is to mitigate the risks as best you can. Conduct background checks, senior team member background checks, third-party reference checks, and audit reviews. Speak with the independent fund administrators, auditors, industry references, and back-channel vendor checks. Operational expertise and scale. Overall fund size relative to their target opportunity. Carefully review and monitor leverage exposure. Of course, there is more to the process, but the above is a good start. It doesn't guarantee you against risk but can help mitigate risk. Ensure you have an experienced research/due diligence team engaged to review and analyze the dangers thoroughly.

The **macroeconomic cycle** is a crucial factor and risk for identifying the type of fund to invest in**. Interest rate** risks must be considered, as rate direction for floating rate funds and credit spreads impact returns.

The use of **leverage** must be considered, even within a senior secure credit fund. If a fund utilizes leverage, you have inherited an additional layer of risk. Thus, it is an essential consideration for your needs, goals, and risk profile. Leverage is not bad in and of itself.

Diversification and portfolio sizing within a fund include the type of credit allocated, diversification among various industries, and the fund sizing of risk exposures (or concentration of exposures). Diversification of strategies can mean increased AUM for a fund manager, but can the private debt fund properly deploy the additional investment dollars effectively (and efficiently), and does it have the operational back office to handle scale?

Manager selection is important. At CMG, we lean on our network of relationships within the industry to source opportunities. We have an experienced team with the due diligence and the business understanding necessary to analyze various opportunities, with the ability to understand the underlying investments within the fund, assess the manager's expertise, and the depth of their business structure, and consider where we are in the economic cycle with the objective of selecting the best investment options for the future.

For many investors, private credit is an unknown asset class, or low-quality bond funds have burned investors; however, from a portfolio perspective, private credit deserves careful consideration as it may provide higher cash flow versus traditional fixed income investing.

Short-Term Private Credit vs. Traditional Fixed Income

Yield Potential: *Short-term private credit funds* often offer higher yields than traditional fixed-income investments. They primarily target non-traditional borrowers and SMEs, which can result in higher interest rates and potentially more significant income for investors. *Traditional fixed-income investments* like government, municipal, or

investment-grade corporate bonds tend to have lower yields due to their lower credit risk profile.

Duration and Interest Rate Risk: *Short-term private credit funds* typically have shorter durations, reducing their sensitivity to interest rate fluctuations. Loans generally are made at SOFR plus a spread. This results in a higher yield and helps mitigate interest rate risk, making them attractive when interest rates rise. *Traditional fixed-income investments* such as long-duration bonds are more sensitive to changes in interest rates. When rates rise, the value of existing bonds can decline, potentially leading to capital losses for bondholders.

Credit Risk: *Short-term private credit funds* may offer higher yields, they also come with increased credit risk, as they often lend to SMEs or non-traditional borrowers. Default risk is a concern, and investors should carefully assess the creditworthiness of borrowers. *Traditional fixed-income investments* such as government bonds are typically considered safer, with lower credit risk. Investment-grade corporate bonds also offer a degree of credit quality.

Liquidity: *Short-term private credit funds* may offer relatively quicker access to capital due to their shorter loan durations. However, liquidity can vary depending on the specific fund and underlying assets. *Traditional fixed-income securities* such as government bonds are highly liquid, and investors can easily buy or sell them in the secondary market but are subject to the risk of loss should interest rates increase.

Diversification: *Short-term private credit funds* may add diversification to a portfolio due to its lower correlation with traditional assets like stocks and bonds. *Traditional fixed-income investments* can also provide diversification benefits but to a lesser extent than short-term private credit.

Conclusion

Short-term private credit funds offer an attractive investment alternative for investors seeking higher income, risk diversification, and protection against interest rate volatility. However, it is **essential to understand the risk characteristics and liquidity provisions**

of private credit funds. Some funds **may come with higher credit risk, and different funds offer varying levels of liquidity.**

Investing in the asset class requires the ability to source and select opportunities. Find a knowledgeable partner with an understanding of the benefits and risks of private credit. Seek niche private lending strategies, understand who they lend to, the collateral behind the loans and the position the loan sits within the borrower's capital structure. Do the lenders have experience? Have they worked through multiple business cycles? Do they have expertise to manage through challenging situations?

We hope you found this paper helpful. If you have any questions, please email info@cmgwealth.com and you can learn more about CMG at www.cmgprivatewealth.com.

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Investors should carefully assess their risk tolerance and investment goals before allocating capital to these funds, as the risk ranges from low to high; thus, certain funds may not be suitable for some investors. We encourage you to work with an experienced investment advisor.

Diversifying a portfolio with a combination of both types of investments may also be a strategy to balance risk and return.

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