FIERA CAPITAL

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Claresholm Solar project financed by Fiera Capital.

Private Credit Essentials: Key Insights and Strategies

What is Private Credit?

In broad terms, private credit, often referred to as private debt, is defined as financing that uses private sources of capital which exclude traditional financial institutions, such as banks.

Private credit loans are directly negotiated between the lender and the borrower, and they are not traded on the secondary market. As a result, extensive due diligence, underwriting and tight negotiation of credit agreements is key in private credit as the loans are typically held until maturity and repayment.

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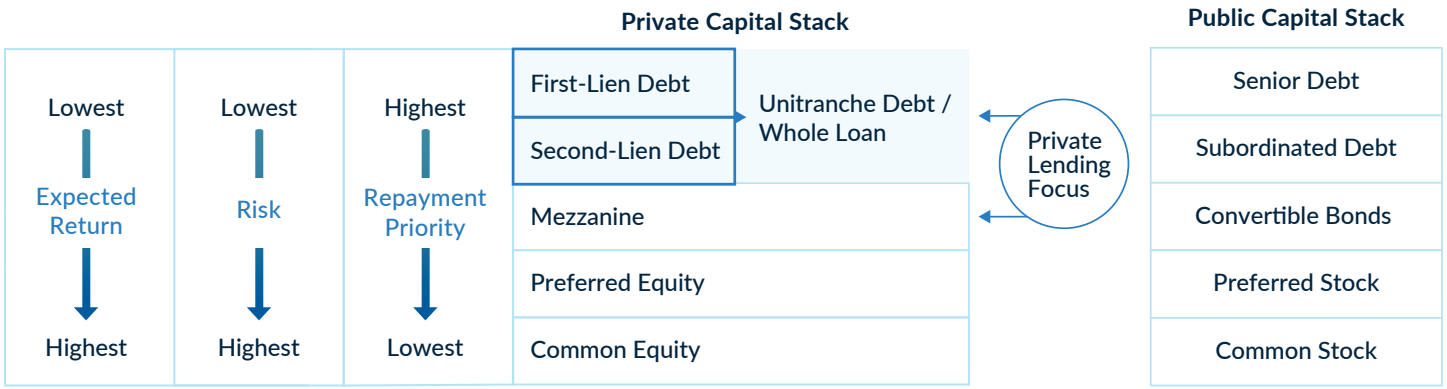
Like public credit, private credit features subsets for its various asset classes. Another key similarity is that both public and private credit rank higher than equity in the capital stack for a borrower, thereby representing a lower risk for the lender. The more senior the loan, the lower the risk for the lender of potentially losing money in the event of the borrower's default or bankruptcy. This means they are first in line to collect interest payments and seek reimbursement. Consequently, the lower the investor or lender's seniority is in the capital stack, the higher the expected return or the interest rate. This is illustrated in the chart below.

There are several key elements that differentiate private credit from public credit. For example, **private credit can offer higher yields compared to public credit because it offers considerable flexibility in structuring more complex transactions, customization and speed of execution, which together can be summarized as the "convenience premium".** In comparison, public credit instruments are typically originated by a bank and sold to the public or syndicated to a large number of private investors, and the loan terms tend to be more standardized in order to be investable by a larger audience.

Public and Private Capital Stack Components



Source: Fiera Capital (November 2024).

> **There are several key subsets within private credit that may be backed by different types of collateral and investment approaches and are worth exploring further.**

Corporate Direct Lending

Businesses often rely on debt to expand their operations, grow or make acquisitions, and consequently, they sometimes turn to private credit to finance these activities. This process is also known as direct lending. Since each business has its own restrictions and unique circumstances, the speed and flexibility of private lenders are among the key characteristics that attract borrowers to this type of private credit arrangement, despite the fact that they often have to pay a higher interest rate. The benefits to the borrower will often largely compensate for the interest rate premium paid. The collateral backing these corporate loans is typically backed by the cash flows and assets of the business' operations.

Infrastructure Private Credit

As the global population continues to grow, the world's infrastructure increasingly requires much more capital to finance maintenance and expansion, which creates numerous potential investment opportunities. Infrastructure investments can potentially provide significant diversification benefits and access to high-barrier-to-entry assets that seek to generate attractive returns and contractual cash flows over a long period. Lending to infrastructure developers or operators gives investors exposure to these opportunities while offering the lender substantial downside mitigation due to the defensive nature of infrastructure assets and the attractiveness of the collateral, which is often the infrastructure asset itself.

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Real Estate Private Credit

Much like infrastructure, real estate is a hard asset with the potential to generate cash flows on its own, unlike other types of hard assets such as equipment or inventories, which require more active and direct involvement to generate cash flows. Real estate financing can be done at different stages:

- **Construction Financing:** Short-term loans, typically backed by land, construction projects and pre-sales of residential units. This stage generates cash yield from interest held in escrow, offering the highest return potential but also exposure to the highest risk.
- **Bridge or Value-Add Financing:** Short-to-medium-term loans, typically backed by underlying real estate property undergoing a transitional period (i.e., not fully leased or converting from one asset type to another). This stage involves a medium range of both return potential and risk exposure.
- **Term Financing:** Longer-term loans, typically backed by real estate property with stable income. This stage offers the lowest return potential but also the lowest risk exposure.

The goal is to have a loan that is at a significantly lower value than the value of the real estate asset, which is calculated using a loan-to-value (LTV) ratio[1]. In the case of construction financing, it is a best practice for the asset manager to consult with a third-party valuator to help ensure that the costs incurred throughout the construction process are lower than the value of the loan disbursed, which is determined using a loan-to-cost (LTC) ratio. Generally, the concept lies in the lender's ability to repossess the asset in case of bankruptcy and have the option to either complete the construction to resell it at full value or dispose of the asset and recover the entire loan value disbursed.

Asset-Backed Finance

Asset-based financing (ABF) consists of loans where assets, either tangible or intangible, are securitized by the lender as collateral. These assets may include accounts receivable, inventory, machinery, equipment or real estate, and can even include patents, trademarks or other intellectual property. These types of loans tend to be more structured, leveraged and one step removed from the end borrower (i.e., originated by an intermediary) relative to the other type of loans previously mentioned.

Distressed and Special Situations

Since the global financial crisis, distressed securities and special situations financing have caught the attention of many investors. This subset of private credit allows the investor or the lender, in restructuring cases for instance, to gain control of the distressed company with the aim of restructuring it, either by reorganizing its balance sheet or actively managing it, and sometimes selling it later at a higher price. This type of private credit requires a deep understanding of the industry in which the company operates, as the situation may involve complex structuring, as well as a keen knowledge of the legal and regulatory environment.

Why Private Credit?

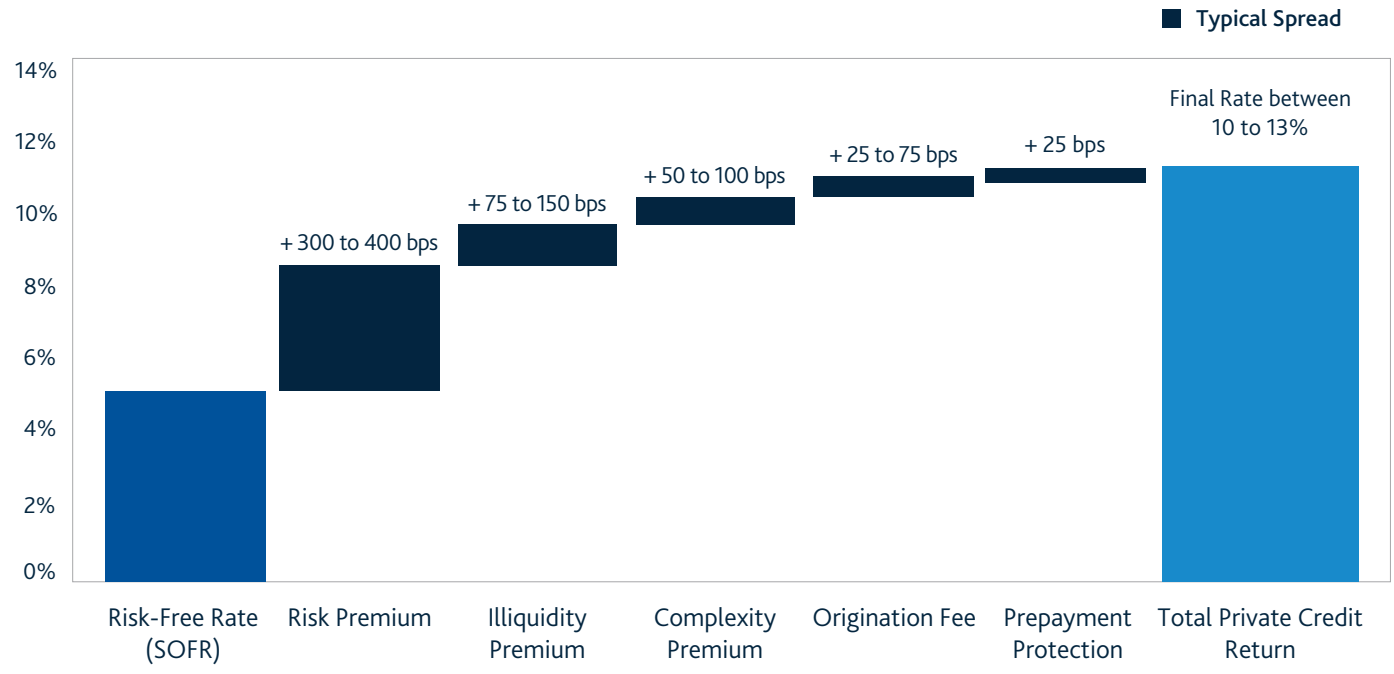
Private credit offers investors several potential benefits as part of a well-rounded portfolio. The most common differentiators offered by private credit include the potential for a strong and reliable income stream, diversification benefits, high risk-adjusted returns and the overall resiliency of the asset class.

Strong and Reliable Income Stream

Private credit managers lend money to borrowers in exchange for monthly or quarterly coupons which, by definition, generate a steady income stream for investors. Private credit returns tend to be higher relative to public credit instruments due to several specific characteristics associated with privately negotiated loans, as illustrated by the example below.

> The components of a private credit return include the risk-free rate (time value of money), risk premium (default risk, which considers several factors including the size of the deal, industry and capital structure of the borrower), illiquidity premium (lack of secondary market, which varies based on the size of the borrower), complexity premium (given customization of the loan to meet borrower's needs) and origination and prepayment fees typically associated with private credit instruments. This results in an all-in gross yield of approximately 10% to 13% for a typical senior private credit loan.

Components of Private Credit Spread



Source: Federal Reserve Bank of New York – Secured Overnight Financing Rate Data as of September 3, 2024; Fiera Capital.

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Diversification

Private credit's differentiated characteristics as an asset class mean that it can likely offer remarkable diversification benefits to investors. Historical correlations between private credit, public bonds and equities show that private credit has a low correlation with traditional asset classes.

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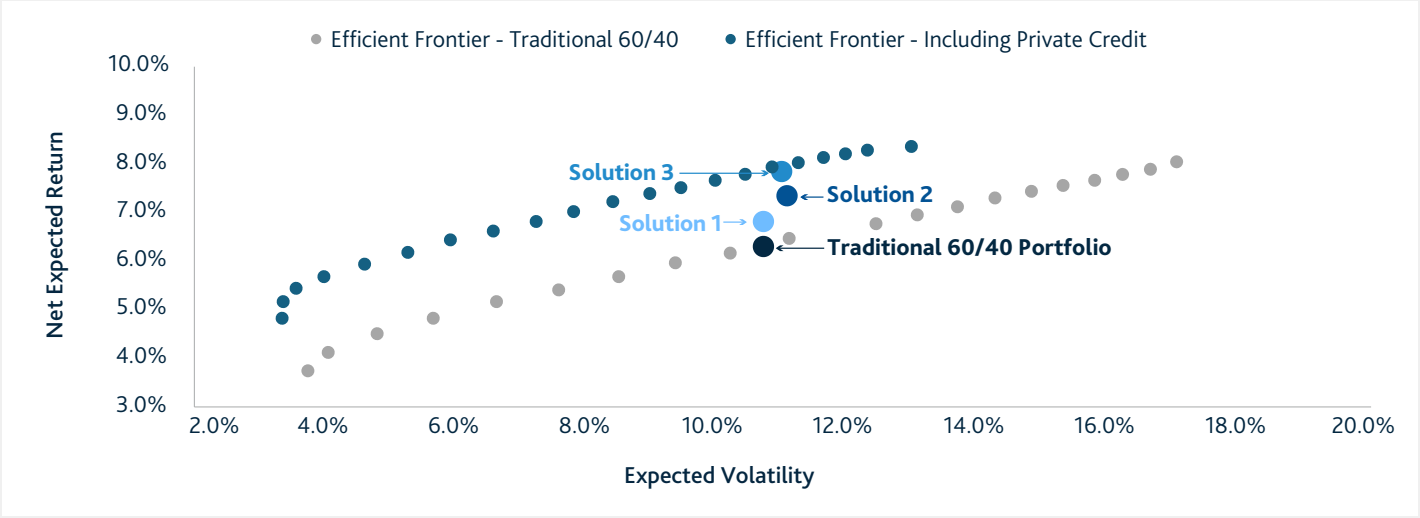
This low correlation is because assets are unlisted and not traded on the public market. Consequently, these assets are much more immune to sporadic short-term market events, making valuations more stable and less correlated to traditional assets. The low correlation, low volatility and competitive return profile make private credit an attractive option for investors seeking a well-balanced portfolio.

The potential diversification benefits from private credit are demonstrated on the chart below, where we start with a traditional portfolio composed of 60% global equities and 40% global aggregate bonds. Subsequently, we have replaced some of the income-producing bonds with private credit strategies, resulting in increased portfolio return while maintaining volatility relatively constant, thus enhancing the efficient frontier.

Private Credit Enhancing the Efficient Frontier



Source: Fiera Capital (November 2024).

Solution 1: Add +10% Corporate Direct Lending.

Solution 2: Add +10% Corporate Direct Lending and +10% Infrastructure Private Credit.

Solution 3: Add +10% Corporate Direct Lending, +10% Infrastructure Private Credit and +10% Real Estate Private Credit.

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High Risk-Adjusted Returns

Risk-adjusted returns are defined as return per unit of risk. Using volatility, or standard deviation, as measure of risk, the private credit asset class (based on a 1:1 leverage ratio) is strongly positioned against other asset classes, as demonstrated in the chart below. Despite offering somewhat lower returns than some other asset classes, such as private equity or infrastructure equity, private credit comparatively involves less than half the historical risk of these asset classes. In other words, this chart below highlights that private credit has historically produced stable returns with moderate risk and compares very favorably to other asset classes on a risk-adjusted basis.

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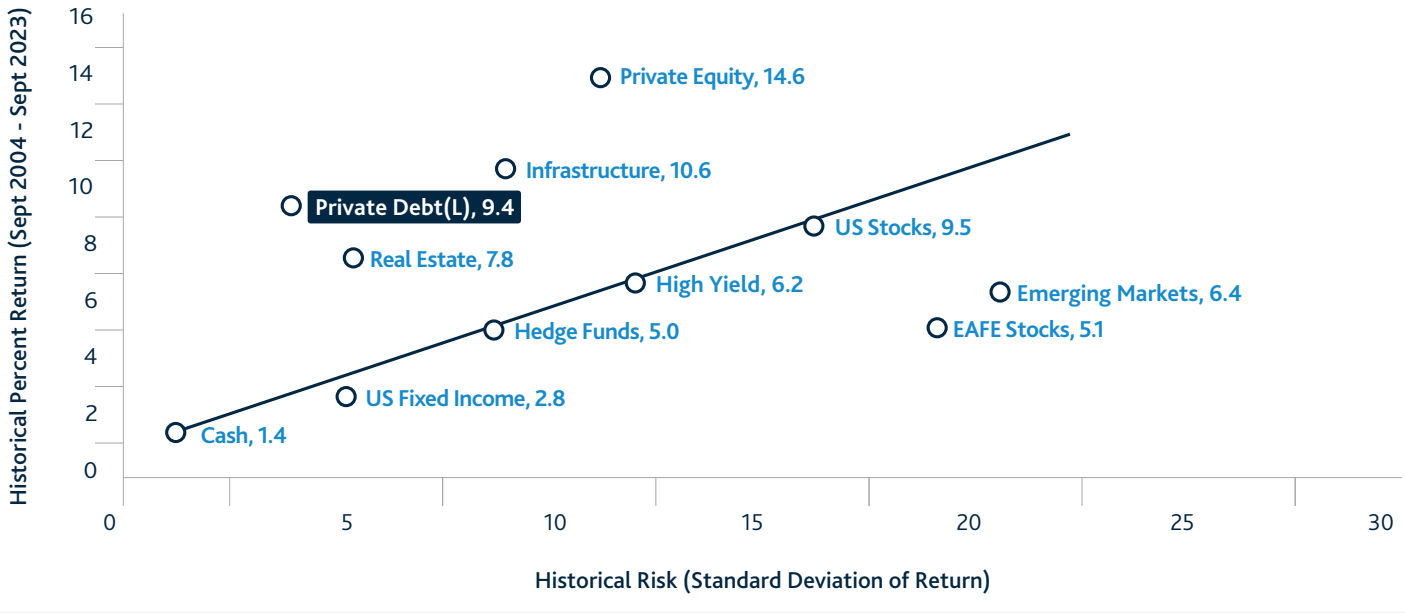
19-Year Historical Asset Class Benchmark Return and Risk



Source: Cliffwater, 2024 Asset Allocation Report, January 22, 2024.

The figure above is for illustrative purposes only, subject to change, and there can be no assurance that any such investment or portfolio will be able to achieve its objectives. Past performance is not a guarantee of future results. Inherent in any investment is the potential for loss.

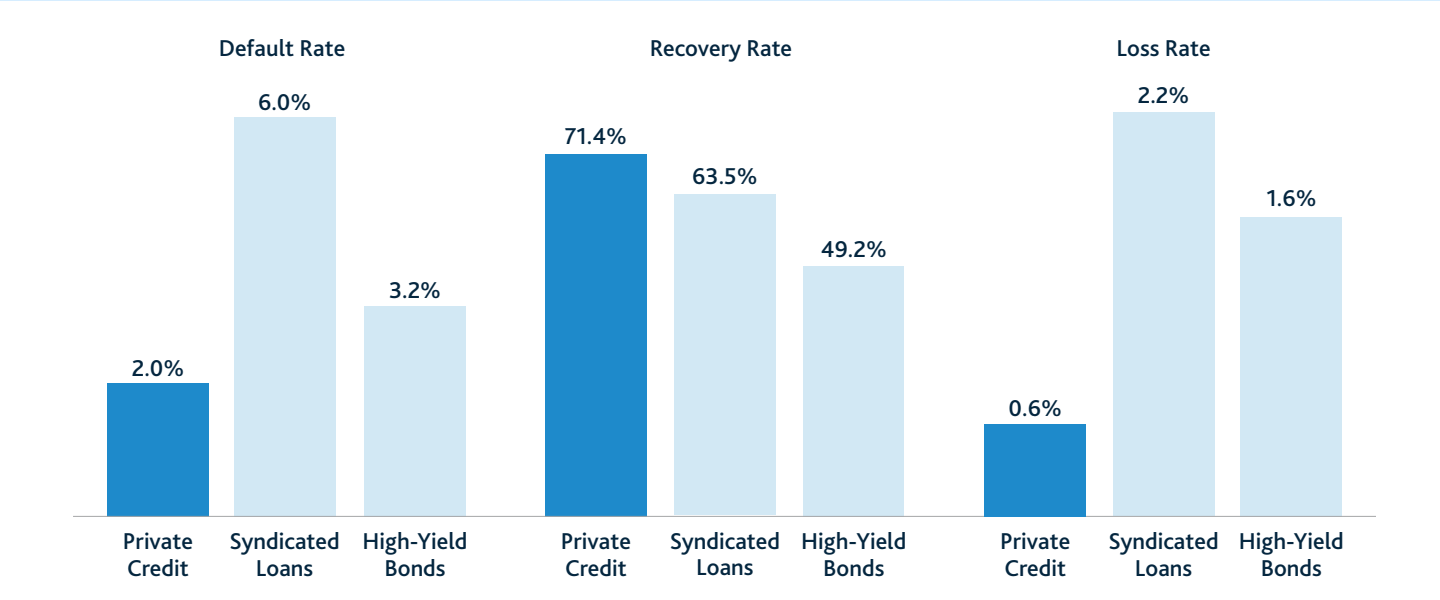
Resiliency of the Asset Class

The historical performance of the private credit asset class has arguably remained constant despite the economic turmoil of modern history, including the global financial crisis (GFC) and, more recently, the COVID-19 pandemic along with its aftermath of record-high inflation and rapidly increasing interest rates. Between 2017 and 2023, the internal rate of return (IRR) for this asset class remained relatively elevated at 8.1%. Preqin anticipates Private Credit to continue performing notably well, with an expected average net IRR of 12.0% between 2023 and 2029.[2]

Since benchmark rates usually increase during periods of inflation, private credit can benefit from floating rate structures, which adjust interest payments based on benchmark rates, effectively providing a hedge against inflation. Additionally, asset-backed loans like real estate private credit and infrastructure private credit have embedded inflation mitigation through the underlying collateral involved. Conversely, in recessionary environments, private credit managers' ability to restructure loans and negotiate terms, such as by increasing spreads or implementing higher floor rates, has helped maintain performance stability. Even in a decreasing interest rate environment, private credit can still seek to offer attractive returns due to the negotiated terms that often lock in higher rates compared to traditional fixed income securities. Consequently, private credit funds have been able to provide steady income streams even when traditional fixed income instruments have faced turmoil.

Additionally, as illustrated by the chart below, **private credit generally has lower default rates, higher recovery rates and lower loss ratios compared to other forms of debt, including syndicated loans and high-yield bonds.** A syndicated loan is a loan provided by multiple lenders to one borrower, typically intermediated by a lead agent. It can be traded in the secondary market and is therefore more representative of a public credit instrument as opposed to private credit.

Historical Resiliency of Private Credit



Source: KBRA Direct Lending Default Report, July 17, 2024, TTM data.

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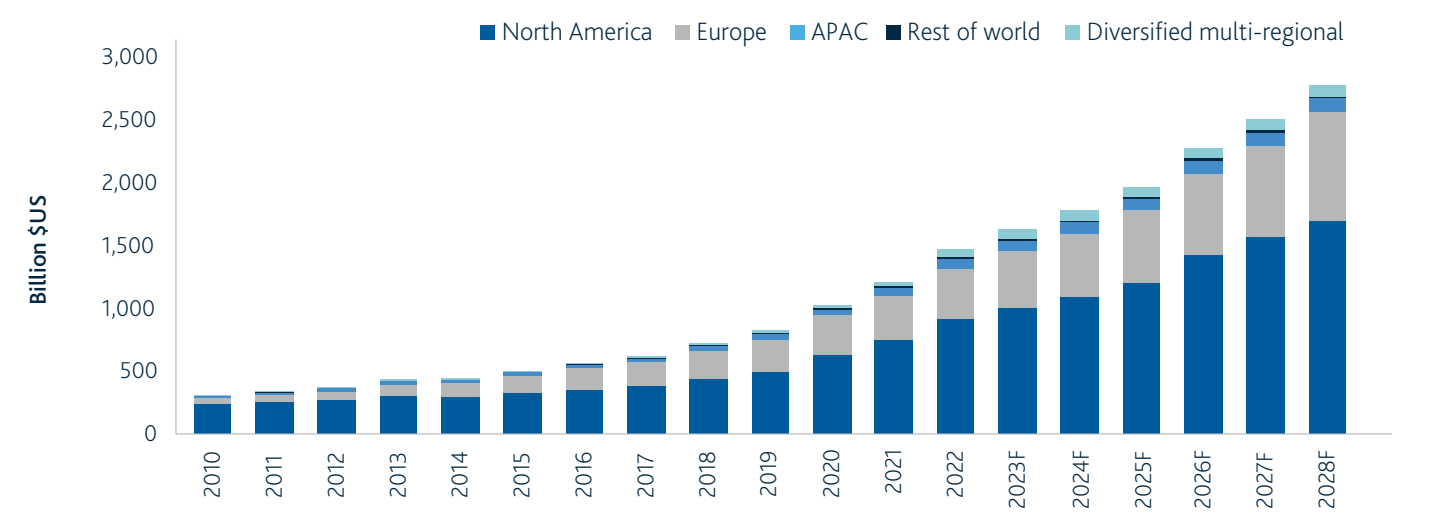
A Bright Future for Private Credit

While banks have historically dominated the credit sector, they have continued to pull back from lending since the GFC. In fact, new banking regulations are increasingly impeding banks from lending to borrowers.

Following the GFC, the introduction of the Basel framework has been one of the key contributors to this shift in the credit space, and Basel IV is likely to add an extra layer of regulations favouring private creditors as opposed to traditional banks.[3] Despite tighter lending regulations, borrowers' need for financing continues to grow, and accordingly, they are finding complementary and alternative sources of credit, specifically private credit. As demonstrated by the chart below, the market for private credit has been growing steadily, with global private credit assets under management (AUM) rising from US$310 billion in 2010 to US$1.5 in 2022, and it is expected to reach US$2.8 trillion in 2028, representing a compounded annual growth rate (CAGR) of 12.9%.[4] To put things into perspective, the global private equity AUM is expected to reach US$8.5 trillion in 2028, up from US$1.4 trillion in 2010, representing a 10.4% CAGR over the same period. Essentially, the private credit sector represented 21.6% of the private equity AUM in 2010 and is expected to reach 32.5% in the next four years.[5]

In response to increased regulations, banks are adapting and finding solutions to their new reality, and as a result, many of them have started to explore ways to partner with private credit funds. Some have even launched their own private credit divisions to maintain their business and profitability while complying with these new regulations, including J.P. Morgan, Citigroup, Wells Fargo and Morgan Stanley, to name a few. These examples not only illustrate the impact of regulations on the banking world but also highlight the significant opportunities that this environment presents for the private credit sector.

Global Private Credit AUM



Source: Preqin Global Report 2024: Private Debt.

Conclusion

As evidenced throughout this paper, the confluence of economic and regulatory events in recent years has caused private credit to become an integral part of the lending sector, and it is poised to continue to grow as institutional investors seek higher yields and borrowers seek alternative financing sources. This shift is creating an abundance of opportunities for private credit investors.

Over the years, the private credit asset class has demonstrated resiliency to market volatility and has recovered admirably following periods of crisis such as recessions and even a pandemic. Despite the long-expected decrease in interest rates in most developed countries, many economists anticipate that interest rates will remain relatively high compared to the pre-COVID pandemic period. Private credit loans are also highly customizable and can be tailored to current and future market conditions, including fluctuating interest rates. This flexibility allows borrowers to negotiate terms that suit their specific needs, making private credit an attractive option in a dynamic economic environment.

From a portfolio construction standpoint, private credit offers potential benefits, as it can provide favourable returns with limited risk and its low correlation with other publicly traded asset classes makes it an excellent diversification tool, in our view. This can help investors achieve a more balanced and resilient portfolio.

The combination of customizable loan structures, a growing market, bank withdrawal, portfolio construction benefits and effective risk management highlights a promising future for private credit. Investors looking for attractive returns, yield, diversification, resilience and stability may find private credit to be an increasingly valuable asset class in the coming years. As the market continues to evolve, staying informed about trends, regulations and best practices will be crucial for success.

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Endnotes

1 "Loan-to-value (LTV) ratio" is an assessment of lending risk that lenders examine before approving a mortgage. Typically, the higher a loan's LTV ratio is, the higher its level of risk.
2 Future of Alternatives 2029, Preqin, September 17, 2024
3 Basel IV Is a Dramatic Global Shift for Private Credit Markets
4 Preqin Global Report 2024: Private Debt, December 12, 2023
5 Preqin Global Report 2024: Private Equity, December 12, 2023

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