A RISING TIDE LIFTS PRIVATE CREDIT

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Private credit plays an increasingly critical role in providing financing to businesses, given current constraints in the public markets and banking sector. For institutional investors, the higher yields and floating-rate nature of the asset class make it particularly attractive in the current interest rate cycle. Private credit has demonstrated an impressive track record over the past decade and continues to attract strong inflows, but success has brought its challenges. Which market segments offer opportunity today? How can managers stay disciplined in the face of a multitude of opportunities to deploy capital? How should asset owners evaluate managers going forward? A rising tide has lifted all boats, but what happens when the tide goes out?

To learn more about the dynamics of private credit today, *Pensions & Investments* spoke with Kevin Sterling, global co-head of private credit at Goldman Sachs Asset Management; Zia Uddin, president of Monroe Capital; and Richard Miller, head of private credit at TCW.

Pensions & Investments: As we come into the latter half of the year, what are the key macro issues impacting private credit, such as banking sector turmoil, credit tightening, a shift in the interest rate cycle and recession concerns?

ZIA UDDIN: All of the above have benefited private credit. While inflation represents a headwind for many prospective borrowers, a higher interest rate environment is a significant benefit to private credit because almost everything we do is floating rate. The income we're getting paid today by our existing borrowers is probably 400 basis points higher than they were paying a year ago. We are entering a golden age of private credit. Private credit has shown resilience versus the public markets. The issue for investors to keep in mind is that a lot of managers came online post the 2008-2009 Great Financial Crisis. It's unclear if they can successfully navigate a more challenging environment.

RICHARD MILLER: We worry about the state of the economy, as a slowdown could cause operating cash flow to decline. If rates continue to rise, that probably means inflation persists. If rates drop quickly, that probably indicates a recessionary environment. The direction of interest rates should be top of mind as it should be a good indicator of the direction that the economy is heading.

Having said that, middle-market direct lending should be a safe harbor, a place to retreat in an uncertain economic environment, because direct lenders are at the top of the capital structure as the senior secured lender. Senior secured debt is supposed to have three valuable hedges: top of the capital structure, floating interest rates and a loan document with covenants, limitations and restrictions. If anything in that document is violated, the lender can return to the table and is able to reassess the risk situation and economic terms.

In the past few years, our market has moved away from some of those critical document protections. Unfortunately, the increased borrower-friendly lending that we've seen over the last few years has diluted many of the protections that this asset class should have never capitulated on.

KEVIN STERLING: Macroeconomic uncertainty is clearly a focus in assessing individual company performance and ability to manage through a changing landscape. Having said that, these uncertainties have also created opportunities for private credit as base rates are higher and credit spreads are wider. Macro factors that impact underlying business performance also present opportunities to deploy capital in creative, solution-oriented ways. To the extent macro concerns increase market volatility, this favors private credit because traditional financing sources become more scarce.

Private credit has grown as an asset class, but it's been part of the financing landscape for decades, including our own history at Goldman Sachs Asset Management dating back to 1996. Borrowers now have a greater suite of financing options within private credit and the opportunity to evaluate larger financings than were available 10 years ago. Private credit has traditionally been priced at a premium to public markets, and we would expect this to continue.

P&I: What tailwinds continue to support private credit — and direct lending in particular? In which segments do you see opportunity?

STERLING: One of the reasons for growth in the asset

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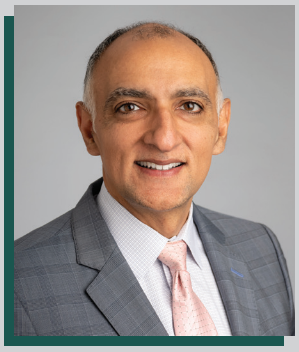

ZIA UDDIN
PRESIDENT
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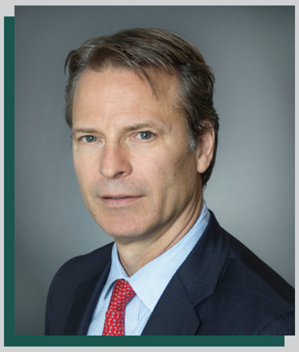

RICHARD MILLER
HEAD OF PRIVATE CREDIT
TCW

class — and some of the pricing premium relative to public markets — is the mutually beneficial relationship between borrowers and investors. Private credit can offer borrowers speed, certainty of execution, flexibility in financing and confidentiality. Meanwhile, investors can benefit from higher yields, lower volatility, downside management and floating-rate exposure, with the cost of capital commensurate with the current environment. Investors can be the most senior in the capital structure, be defensively positioned and earn compelling risk-reward returns.

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UDDIN: There is structural supply-demand imbalance. One is an imbalance between the availability of direct lending dry powder versus private equity dry powder. That's good for the industry and one of the reasons why private credit is growing. It looks like this imbalance will persist for the foreseeable future.

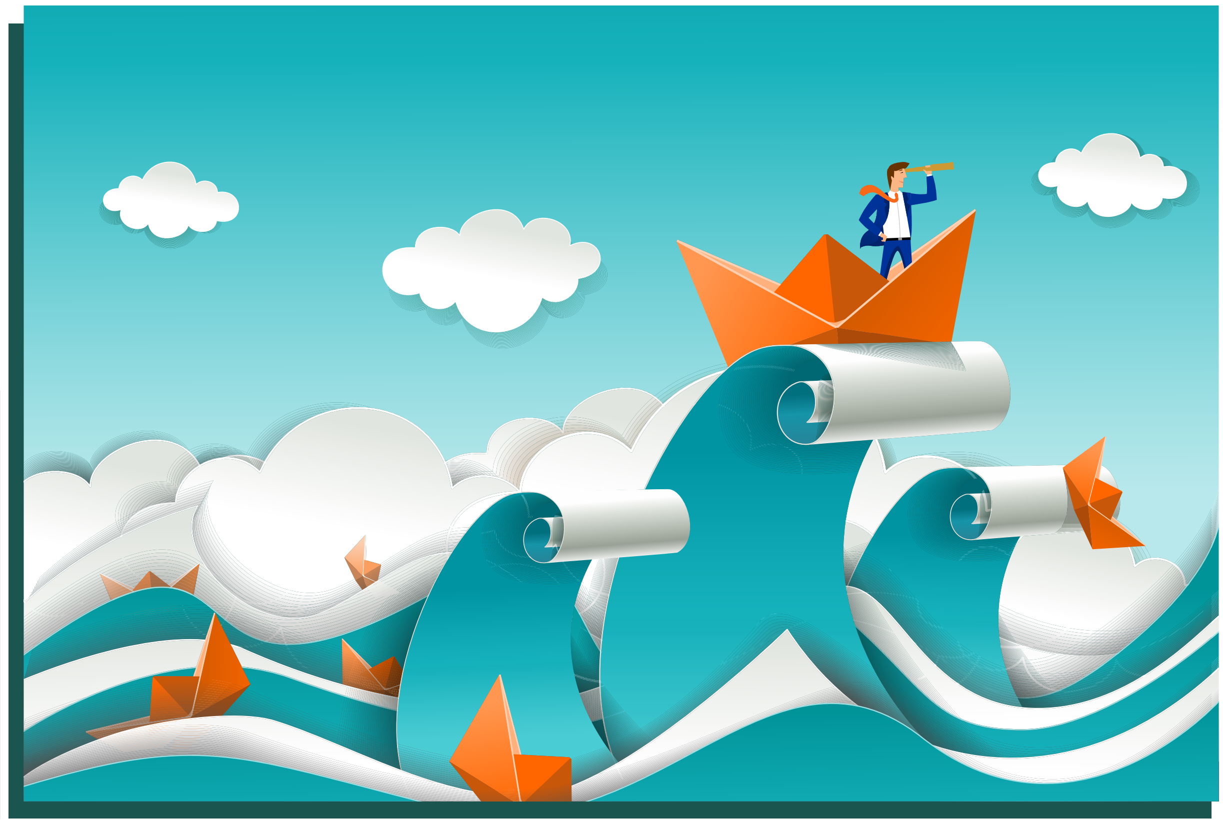
The second part is the regional banking system. When banks go through crises, there's more regulatory oversight and they pull back, which shifts market share from the banks to the private credit arena. From a tailwind perspective, it's simple supply and demand. But there are certain segments where there are bigger opportunities, most notably in venture debt. Silicon Valley Bank, one of the largest players, and others have gone away, so now there is a tremendous opportunity there for other firms to step in and fill that vacuum.

Lastly, another important area of focus is investment strategies that are asset oriented, which is how we see opportunistic credit. Having a nimble asset-oriented and asset-backed investment product allows asset managers to take advantage of dislocation in the market or volatility in certain segments.

MILLER: A contributing factor to AUM growth has been the search for yield by institutional investors and retail investors alike. In a higher rate environment, investors benefit from the floating rate structure of senior loans and enjoy the increases in base rates. However, in an economic slowdown, investors should expect base rates to decline and corporate credit risk to rise. In that environment, where else would you rather be than the top of the capital structure? That's a powerful seat to be in, especially if a borrower begins to struggle. Senior secured lenders have a host of remedies to pursue should a borrower underperform. With the proper loan documentation in place, lenders can take advantage of actionable triggers in periods of underperformance to work collaboratively with the borrower, including providing liquidity relief, providing additional capital, working through a restructuring or, in a more extreme case, owning and operating the business.

P&I: What specific portfolio objectives does private credit help meet today? Has that shifted since the start of this rate cycle?

MILLER: First and foremost, private credit's sole objective should be preservation of capital. A manager must prioritize risk mitigation above all else. If you can avoid principal losses, you will survive in this marketplace for a very long time. TCW Private Credit has been a consistent presence in the market for almost 23 years. In an uncertain climate, return of capital sometimes is more important than return on capital.



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UDDIN: Private credit provides a steady, predictable current yield with less volatility than other risk assets. The highs are not as high and the lows are not as low as valuations are primarily driven by underlying fundamentals and returns are driven by contractual coupons, rather than dramatic swings in fair value. Over the last 10 years, institutional investors have not had a lot of options for yield, which drove the growth of the private credit asset class. Today, they have other options. So how does private credit compete? It has to deliver the second piece of the equation, which is lower volatility and less risk of loss, even in a potential recessionary environment.

STERLING: From the limited partnership and asset allocator perspective, this is an opportunity to potentially reallocate a portion of the fixed-income portfolio to private credit in order to achieve greater cash income. You could also potentially reallocate a portion of your private equity portfolio into a strategy that is focused on capital appreciation, such as hybrid capital, which bridges the gap between pure credit and pure equity.

P&I: Have deal structures changed or underwriting standards tightened, and if so, why? What key features do you focus on?

UDDIN: Loan-to-value ratios continue to come down. Covenants and the definition of EBITDA is tighter. One reason may be that lenders are waiting until they see better opportunities. At Monroe Capital, we're focused on cash flow, not EBITDA [or earnings before interest, taxes, depreciation and amortization]. It's a simple question: Are the cash flows adequate to meet the needs of the business as well as service their debt? It's shocking how many lenders are not focused on this. EBITDA is important, but we're focused ultimately on cash generation. The good news is that we've maintained this disciplined underwriting process for about 20 years.

STERLING: The direct lender community remains focused on credit documentation and covenant protections around lending. That is further elevated in this environment, but it is something that we are focused on at all times and has been a consistent approach throughout our decades of investing.

MILLER: Senior secured loan structures and underwriting standards should always be tight. There is little to be gained from loosening such standards. Announcing a return to more conservative lending is not a good sign for a manager. If someone is changing standards dramatically, investors should beware.

P&I: Private credit represents a spectrum of strategies. What is your area of focus and why?

STERLING: We believe private corporate credit is particularly compelling. From a yield perspective alone, private credit has historically maintained a premium over public markets across multiple economic cycles. We believe this will likely continue.

Within the Goldman Sachs Private Credit Asset Management platform, we're able to finance high-quality companies in a yield environment that's at 10-plus percent unlevered yields. Investors are also the most senior in the capital structure and thereby more defensively positioned.

What private credit and direct lending offer today is not just elevated yields, but also the ability to structure transactions. We focus on documentation, making sure that the protections that we want are well outlined and well structured. What private credit can potentially offer an LP is a fixed-income equivalent that can be defensive in nature and floating rate, at a premium to what the public markets offer. It is an income opportunity, a defensive-play opportunity and exhibits superior relative risk-adjusted returns.

MILLER: We are a lender to middle-market borrowers with at least $15 million of EBITDA, although our average borrower generates closer to $60 million of EBITDA. The TCW Private Credit strategy was designed to deliver a premium return while focusing on preservation of capital. We have been able to generate these returns with a risk profile at or below the conventional market by investing in the misunderstood, the complicated, the less popular — or deals overlooked by the conventional market. We also made the conscious choice to lend to both sponsored and nonsponsored borrowers, enabling us to remain highly selective and find situations with the right risk-reward balance. This approach has kept us in a unique lane.

UDDIN: At Monroe Capital, we try to add value where we have an edge, which is to create alpha for our limited partners. The edge can be in information, inefficiencies in the market or via our long history of types of deals in certain sectors. Our area of focus is direct lending to lower-middle market companies with EBITDA of $35 million and under. Venture debt is another. These markets need specialization and offer a creative opportunity to earn alpha. We can leverage our core capabilities in origination as well as our bottom-up philosophy in underwriting and heavy focus on portfolio management and monitoring. The value that we can offer as private credit providers is transaction execution, tailored bespoke solutions and more incremental dry powder to go on the offense.

P&I: Have you adapted your strategy to navigate current market dislocations in order to find opportunistic or selective investments?

MILLER: No. This asset class should not be vintage sensitive. This is a good time to be investing in it, but the return profile should not be any better than what it was historically, aside from the higher underlying base interest rates. A private credit manager should always maintain a disciplined approach and be a consistent investor in all investment environments.

UDDIN: Now is not the time to reach for risk and go overboard on deployment. As lenders, we're pessimistic and conservative in nature. Managers that have dry powder in a chaotic environment tend to have better and more attractive relative terms. Those terms will get more attractive over the coming quarters as the cycle plays out. If you're patient and disciplined, it works out in the long run.

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STERLING: Across our direct lending franchise, we have not changed our investment philosophy in order to find opportunities to deploy capital. We remain focused on the core tenets of our underwriting process. When evaluating credits, we look for recession resilient businesses with predictable business models that have a differentiated product. We focus on the borrower's ability to generate free cash flow. We then overlay credit documentation, which is critical to create the enhanced protections and monitoring that we want as a lender.

P&I: How are investors accessing private credit — closed-end funds, interval funds, business development companies?

UDDIN: The closed-end drawdown vehicle still remains a dominant structure and one where we are seeing innovation. For example, there are tax treaty structures that make it more advantageous for offshore investors to invest. For tax purposes, there has been tremendous growth in private and unlisted BDCs, which are evergreen in nature and also offer investors some liquidity after a period of time. This taps into the wealth management channel as well, which is vastly under-allocated to alternatives and private credit. But the industry needs to be careful there's not too much of a mismatch between the duration of assets and liabilities. These are illiquid assets.

STERLING: There are different types of vehicles and structures that are available to access private credit. The two main ones in the market are the business development company structure and traditional drawdown funds. The BDC is more income focused, with recent iterations, namely the non-traded BDC, deploying capital instantly and providing quarterly liquidity. Traditional drawdown funds deploy capital over a multiyear period and returns to investors are a combination of income and capital appreciation. The BDC product has also become popular with retail investors and has gained momentum in recent years.

MILLER: Investors are using all kinds of different vehicles to structure around their needs, wants and requirements. There is no one-size-fits-all vehicle. Investors need to understand they are investing in an illiquid asset class. There's no secondary market for trading middle-market senior loans. The managers of these various structures have to be very clear on the limitations of the attributes they're selling to investors. That said, by and large, the introduction of new structures is a healthy evolution of the asset class.

P&I: What should investors look for in a private credit manager? What characteristics drive success?

STERLING: In our view, there are four key pillars to look for in a manager, the first one being capital. You need to be of critical size to be impactful. But you must also have the capacity and flexibility to solve borrowers' needs across the capital structure in all types of markets and market conditions. The second key pillar is people. You need a tenured, experienced investment team that has expertise in sectors and geographies and can provide local knowledge and a comparative perspective. The third key pillar is resources that are complementary to the investment team's knowledge and experience. Do you have colleagues in private equity within the same platform to hear what they're seeing on the ground? Can you bring in tax, legal, accounting and industry knowledge?

The last pillar, which we believe is absolutely fundamental, is origination capacity as an investor. You want the widest funnel possible from which to evaluate new investments. Goldman Sachs Asset Management has an exceptionally wide funnel. We invest in only a small percentage of the opportunities that we see. Combining capital, relevant and experienced people, the right resources and a wide origination capacity allows the credit manager to be selective and to use their experience to inform investment decisions.

MILLER: Private credit has been a great beta trade since 2010. It has been a benign, favorable environment in which to be a lender. Everyone's returns have bunched together. There hasn't been a lot of differentiation. That's about to change.

The next four or five years are going to be very different from the previous 12 years. Many managers have never managed through an extended economic slowdown or widespread defaults. Investors should look for managers with an extensive body of work managing through underperformance with a well-developed playbook to actively work though challenging times. We believe that

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managers should have a consistent investment strategy and risk approach; be positioned to take advantage of tight and restrictive loan documentation, including actionable financial covenants; emphasize modest leverage ratios; and, generally, invest in a more pessimistic fashion to protect downside risk. Investors should seek a manager who has shown the ability to nurse underperforming companies back to health, operate in restructurings and navigate through bankruptcies — in essence, one who can utilize and pursue all of the remedies available as a senior secured lender.

The most important objective in this asset class is to avoid principal loss. If you can do that, your investors will thrive and you will endure for years across cycles. We're proof of it.

UDDIN: When evaluating private credit lenders, you have to view them on their worst deals. Understand their real workout capability, their proven track records, their tenure, how disciplined they are. The challenge is that it's hard to find a direct lender or private credit manager who hasn't made money in the last 10 years.

The difference between now and the next couple of years is going to come down to the experience level of the private credit manager. Deploying money is easy; what is difficult to achieve is, how do you get that money back? In the U.S., there are not a lot of managers like Monroe Capital with a track record going back nearly 20 years; most of them have 10 to 12 years. It's hard to draw a conclusion on that time frame because it's been a bull market for the industry.

P&I: What's your near-term outlook for private credit? What aspects will become more important for investors looking to enter or expand their allocations?

MILLER: It has been a very favorable time for private credit. But in an uncertain economic climate and possible contraction, where do you want to be positioned? What is safest for investors is to be at the top of the capital structure, in a secured position, with a restrictive loan agreement that contains triggers if a company deviates materially from plan.

TCW Private Credit has three primary objectives today. One is to protect the investments we've made in the past that exist in our legacy portfolios. With our consistent underwriting approach, we're well positioned for that. Second is to take advantage of a thinned out competitive landscape where there are fewer eager lenders. Despite the amount of dry powder in the market, most middle-market lenders are waiting for the private equity sponsor buyout activity to return before becoming more active. Third, there's going to be an opportunity within private credit to take advantage of overly aggressive lending that has taken place in recent years and weak loan documentation. Add to that the significant rise in interest rates and a potential economic slowdown and you've got the ingredients for stress within the middle market. This should create a very attractive investment opportunity for experienced managers.

STERLING: We're excited about what private corporate credit can potentially offer to borrowers in terms of value because of the mutual beneficial relationship with lenders. Because of that, we're positive about the potential risk-reward opportunity that this asset class offers to investors. We're in a higher interest rate environment, with macro pressures on banks, which we believe creates an opportunity for nonbank lending markets in private credit.

Goldman Sachs Asset Management has been investing in private credit for 25+ years and has invested across various economic environments by staying focused on our core investment philosophy and being selective in our approach. Being connected to a Tier 1 investment bank provides a valuable sourcing engine that allows us to be selective. Our size and scale, longevity in the space, benefit of incumbencies and large underwriting team with deep specialization are key differentiators.

UDDIN: Higher interest rate environments drive higher returns. But can you manage the risk of loss? Higher defaults just mean you have a seat at the table sooner than before. If you structure the deals conservatively and monitor them on a hands-on basis, you can deliver equity-like returns through this vintage. If you have the dry powder, you will get the best opportunities.

This should be a golden era of private credit for the managers who know what they're doing. Monroe delivered very high returns through the Great Financial Crisis. It was because if you're disciplined, you can dictate better terms when people need capital and markets are not operating in their historical norms. ■