

Opportunities in Private Credit

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Why Private Credit?

Private credit has experienced rapid growth and evolution over the past decade. Today, it is a \$1.7 trillion asset class, expected to almost double in size over the next five years.¹ While most of the capital invested in private credit is on behalf of institutional investors, more advisors are recognizing the asset class's benefits and potential to provide a reliable source of income with strong downside protection for their investor clients.

Navigating this asset class, however, can be daunting for the advisor given the number of private credit managers marketing products and the lack of transparent data around the asset class.

The writing of this whitepaper was, in part, a response to the negative press coverage there has been on private credit over the last several months, particularly in the Canadian media. While some of this is well founded given some of the challenges being faced by certain managers, it's not fair to paint private credit with the same broad brush.

This whitepaper is intended to “set the record straight” by taking a wider look at the world of private credit, how it works, the different flavours of private credit, the inherent risks, its long-term track record, and how investors can set themselves up for success. That is possible, but it requires careful due diligence by the investor and advisor to ensure manager selection decisions are thoughtful and well-informed. Successful private credit investing requires skill and expertise, and not all managers have that edge.

¹Preqin

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Part 1. The Market Environment

With the advent of the Dodd-Frank Act in the US following the 2008-09 Global Financial Crisis, increased regulation has limited the ability of the banks to conduct certain lending activities. As a result, private credit funds have emerged as a critical source of financing, especially for mid-sized companies that are often overlooked by larger financial institutions.

The participation of the banks in the US loan market has shrunk dramatically. Today, over 80% of the US loan market is accounted for by non-banks such as institutional investors and finance companies.² This dynamic is different in Canada where the banks still dominate the lending market. Tightening risk capital considerations, however, are requiring them to be increasingly selective in which opportunities they lend to. Given this, there are far fewer private credit managers in Canada versus the US.



² Pitchbook LCD, as of December 31, 2022

Part 2. What is Private Credit?

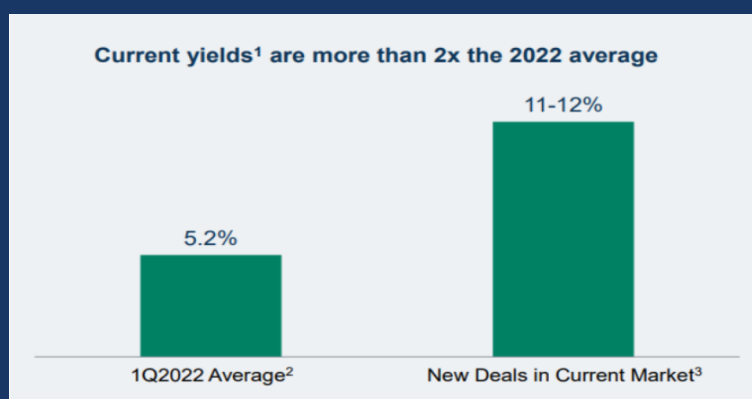
Private credit investments are non-publicly traded investments provided by non-bank entities, such as alternative asset management firms, that fund private businesses. Managers invest in directly originated loans to businesses that can't or don't want to access public markets for their capital needs, and private credit investors seek to provide borrowers with tailored solutions.

One feature that generally makes private credit compelling is the contractual return component it offers. There is a legal promise of return of capital and, in most strategies, a promise of payment of interest or other contractual return. Private credit offers higher yields than traditional below investment-grade fixed income investments such as high yield bonds and leveraged bank loans and may offer attractive diversification benefits. For this reason, private credit could be viewed as a risk mitigation tool relative to holdings in equities.

- Private credit investors benefit from focusing primarily on making first-lien loans, which sit at the top of a company's capital structure with the first claim on a company's assets in bankruptcy, thereby limiting potential losses from defaults. These types of loans are called direct lending investments.
- These loans are usually held by one or a handful of lenders as opposed to the broadly syndicated loan market, where there are typically dozens of holders of a single issuance, making workout negotiations less complicated and easier to navigate.
- Unlike syndicated high yield and investment-grade bonds, private credit loan contracts usually include financial maintenance covenants, which are typically tested quarterly based on the financial performance of the borrower. They protect lenders by imposing certain limits such as maximum leverage or minimum EBITDA. Covenants help private lenders spot early signs of financial stress and address them before they lead to more serious challenges. These attributes allow investors to maximize the recovery value of the investment in a default scenario.
- A significant portion of borrowing in the private credit space is backed by one or more private equity firms. In times of financial stress, the private equity sponsor may provide an equity injection to help the borrower stay afloat, thus reducing credit risk. Historically, "sponsored transactions" have helped private lenders generate relatively stable returns for their investors over long periods of time.

The chart below shows the current levels of yield available in private credit relative to where yields were in Q1 2022. The yields available in the current market environment are significantly higher than they were only several years ago, benefitting from the dramatic rise in US short-term interest rates over the intervening period.

Exhibit 1³



Source: Pitchbook LCD, as of December 31, 2023 1. Yield to Maturity. Yield to maturity is a concept used to determine the rate of return an investor will receive if a long-term, interest-bearing investment is held to its maturity date. 2. Represents companies with EBITDA > \$50 million. 3. Based on recent deal activity and Oaktree market observations.

³ Pitchbook LCD, as of December 31, 2023

Part 3. Common Private Credit Strategies

Private credit offers investors a range of options for preserving capital, generating current yield, or benefiting from capital appreciation. Historically, private credit has offered higher income and lower losses than other fixed income segments, such as senior loans and high yield bonds. Highlighted below are the common private credit investment strategies that are offered by alternative asset managers.

Direct Lending

Middle-market loans, primarily cash flow based, that are issued to private equity or founder-owned businesses. Investors find these loans attractive because of their capital structure seniority, stronger covenant packages, floating rate nature and high levels of current income. According to Preqin, direct lending now makes up close to half of total assets invested in private credit.

Mezzanine Financing

This is the middle layer of the capital structure that falls between secured senior debt and equity (i.e., subordinated capital). This type of capital is usually not secured by assets, and it is lent strictly based on a company's ability to repay the debt from free cash flow

Asset-Backed

Specialty lending is where the loan is collateralized by the company’s assets, cash or receivables.

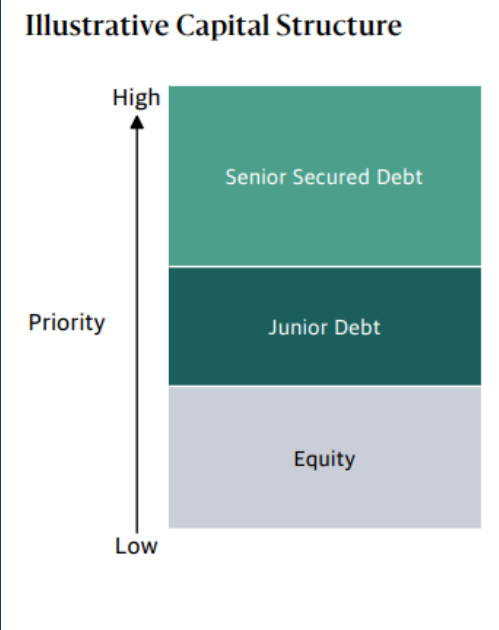
Opportunistic Lending

Lending to performing companies with acute financing needs (e.g., liquidity or maturities).

Distressed Debt

Involves buying the debt of an issuer that is unlikely to meet its obligations as promised. A typical distressed strategy would buy the debt at deeply discounted prices that later gets converted into equity. Distressed investing requires significant restructuring expertise.

Exhibit 2

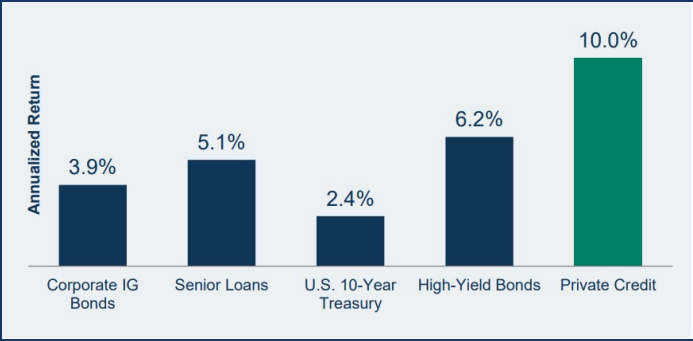


Part 4. How Has Private Credit Performed?

The primary return driver for private credit is interest income, although additional drivers of return may include origination fees, transaction fees, prepayment fees, and equity investments and/or warrants. Negative drivers of returns are default and recovery rates, typically condensed into a single statistic of loss rate.

The chart below shows the annualized historical returns of private credit, according to the Cliffwater Direct Lending Index, relative to various public market fixed income indices for period 2010-2023. The Cliffwater index was the first published index tracking the direct lending market. It currently covers ~15,600 directly originated middle-market loans totaling \$337 billion.

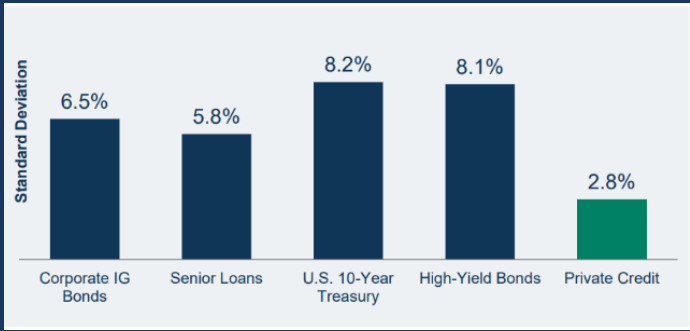
Exhibit 3



Source: Bloomberg, Cliffwater. January 1, 2010, through December 31, 2023 Past performance is not indicative of future results.

Not only has private credit outperformed over this period, but it has done so with considerably less risk as shown in the chart below. One of the important benefits of owning private credit investments is that they are less affected by market beta and investor sentiment. They are not subject to the mark-to-market volatility investors experience in publicly traded fixed-income assets, particularly in risk-off environments during market downturns.

Exhibit 4



Source: Bloomberg, Cliffwater. January 1, 2010, through December 31, 2023 Past performance is not indicative of future results.

For example, over the 10-year period ending 2023, the Bloomberg US High Yield Index declined in value in three calendar years (2015, 2018 and 2022). In those three years, the Cliffwate index generated positive returns. Private credit has been a resilient asset class in times of market stress

Part 5. Understanding Key Risks

While private credit offers attractive benefits, just like with any investment, investors need to understand the associated risks. The following summarizes some of the primary risks the investor needs to pay attention to.

Liquidity Risk

Private credit has the potential to provide higher current income and returns than comparable below investment-grade fixed-income alternatives by taking advantage of the illiquidity premium, or the potential for excess return for investing in assets that cannot easily be converted into cash. Direct Lending, for example, can potentially add 200–500 plus basis points of additional yield relative to the traditional syndicated corporate loan market.

Leverage Risk

An investor considering a private credit fund investment should understand whether the fund employs leverage as part of its management strategy. While the target returns of a fund that takes leverage would be higher than one that didn't, its risk level would be commensurately higher. Leverage applied to any investment adds more risk.

Company (Borrower) Risk

Different private credit managers will focus their investments on different segments of the borrower market. These include the lower middle-market, the middle market, the upper middle market and the large market. For example, the lower middle-market would include companies earning \$10-\$25 million of EBITDA, while the large market might be companies with over \$250 million of EBITDA. Typically speaking, a larger company might be expected to be more resilient in an economic downturn, while a company operating in a highly cyclical business such as energy would be expected to have more cash flow volatility than a company operating in a recession resilient industry such as healthcare.

Sponsored or Non-Sponsored Transactions

The manager of a private credit fund will typically originate their investments from a variety of different channels. Whether or not they source sponsored or non-sponsored transactions is an important distinction.

In a sponsored transaction, a private lender provides debt financing to a business that is owned by a private equity (PE) firm. The PE firm provides an extensive due diligence package and uses its relationships with private lenders to help negotiate a competitive loan. In such situations, as the PE firm owns the equity in the business, a sponsor backed private credit investment is considered less risky than a non-sponsored transaction. As the PE firm has “skin in the game”, it helps to de-risk the transaction for the private lender.

In a non-sponsored transaction, a private lender works directly with the borrower without a bank, sponsor or other intermediary. As such, the private lender is responsible for all aspects of due diligence and underwriting. These transactions are usually considered higher risk given that the lender is not partnering with a PE firm on the transaction. Because of this, the lender might be able to extract a higher return on their investment.

Part 5. Understanding Key Risks

Manager Selection Risk

As with all private market investments, performance dispersion in private credit is wide. Selecting top-tier managers is essential for tapping into the full potential of private credit and earning an illiquidity premium. The two pillars of successful private credit investing are deal origination and underwriting, both at closing and ongoing through monitoring. Partnering with managers who have a proven track record, expertise in assessing credit risk, and a history of recovering investments is essential.

Structure

Typically, private credit investments are structured such that the borrower pays regular income to the lender. An investor in a private credit fund needs to regularly monitor which investments in the fund's portfolio, if any, are no longer paying cash interest. If certain investments are in non-accrual and/or have a PIK structure, that might be a cause for concern.

Non-accrual is a loan that has missed has an interest payment i.e., loan has become non-performing.

Payment in Kind (PIK) is a where the interest on the loan is not paid on a regular basis but instead added to the outstanding loan principal with payment deferred typically to the end of the loan's term. Because of this, PIK loans are considered riskier. PIK loans give the borrower a chance to delay making interest payments in cash and in return for the delay, they typically agree to offer a higher rate of return on the loan. These loans are more common for technology companies and other growth sectors where existing cash flows wouldn't necessarily allow for both continued investment and debt servicing.

Diversification

Diversification is another key aspect of risk management. Investors should ensure their private credit investments are appropriately diversified across multiple sectors. As no one manager can capture the entire private credit opportunity set within a single fund, manager diversification can be a prudent approach.

Part 6. Allocating to Private Credit

For those investors that feel private credit might be a fit for them, how should they invest and from where in their portfolio should their private credit investment be funded?

For investors seeking to generate additional sources of income in their portfolio, they might choose to fund a private credit investment from their traditional fixed income investments. For example, a 10% private credit allocation could be funded by reducing liquid traditional fixed income investments from 40% to 30%. If private credit, for example, is yielding 10% versus 5% from a traditional fixed income portfolio, the decision to add 10% private credit could generate 0.50% of incremental yield in the portfolio. This could clearly enhance the portfolio's overall return potential but possibly at the expense of a more elevated overall risk level given the new lower allocation to traditional fixed income investments. Historically, high quality fixed income investments have been attractive portfolio diversifiers.

Alternatively, an investor could choose to fund their private credit investment from equities, traditionally the riskier part of a portfolio. For example, in a traditional 60/40 portfolio, the investor might fund a 10% private credit investment by reducing their public equity holdings from 60% to 50%. In this scenario, it is likely that the overall risk of their portfolio could be reduced by more than any decline in the return potential. Put another way, this decision might improve a portfolio's risk-adjusted return potential. This option would make sense for an investor seeking to use private credit as a source of risk mitigation within their portfolio

Regardless of whether the investor chooses to fund their private credit allocation from traditional equity or fixed income investments, it will result in a new portfolio with less immediate liquidity.

Part 7. Closing Remarks

Private credit is an attractive asset class that should be considered for inclusion within a well-diversified portfolio. Its income yielding and defensive qualities might act as a source of risk mitigation relative to holdings in equities.

In today's market environment, private credit looks appealing given the opportunity to earn significantly higher cash yields relative to several years ago – yields that are comparable to or higher than the long-term average of equity indexes.

The flip side is that having to pay those higher rates of interest can cause stress at the individual borrower level. Investors should recognize that not all credit managers are created equal. They are not equally capable of originating attractive investment opportunities, underwriting those same opportunities and working through an investment that may be challenged for whatever reason. Investors need to place their emphasis on seasoned managers that have the experience and resources to manage a portfolio of investments through the ups and downs of an economic cycle. As is always the case with investing in alternatives, manager selection is critical.

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Obsiido is a technology enabled investment management firm that specializes in researching, structuring, and enabling investments in core alternative investment opportunities within private markets and hedge funds. Obsiido is registered as an investment fund manager in Ontario and as a portfolio manager and exempt market dealer in Ontario, British Columbia and Alberta.

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