Private Credit Investing: Unveiling the Benefits of an Alternative Asset Class

This white paper aims to explore the benefits of private credit investing as an alternative asset class for Canadians. Private credit has gained significant attention from institutional and individual investors alike due to its potential for attractive risk-adjusted returns, portfolio diversification and downside protection. Through an in-depth analysis of key characteristics, investment strategies and market dynamics, this paper highlights the advantages of asset-backed private credit investing and its potential to enhance portfolio performance in today's evolving investment landscape.

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Introduction

Private credit is best described as credit originated by non-bank lenders, such as specialty finance companies, that are not traded or issued on public exchanges. While private credit is not a new market segment, it has dramatically increased its footprint since the Great Financial Crisis (GFC) of 2007-2009. The fallout from increased banking regulation post-GFC led to banks shrinking their lending balance sheet and narrowing their credit box for prospective borrowers. This, coupled with a voracious demand for credit amid low interest rates, allowed private capital to fill the supply void, with private equity leading the way. In addition, the reduction in the number of listed public companies led to more private companies requiring financing alternatives.

In this environment, private credit investing has emerged as an attractive alternative asset class, providing investors with unique opportunities to diversify their portfolios and seek attractive risk-adjusted returns. Unlike public debt instruments such as corporate bonds, private credit investments involve direct lending or investing in the debt of privately held companies or non-publicly traded assets.

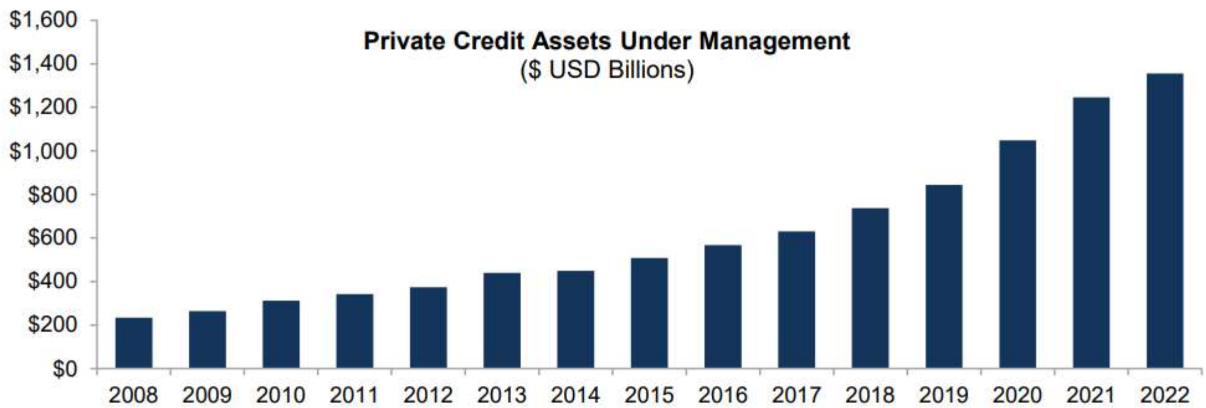
Direct lending is the most popular type of private credit, where non-bank lenders provide capital to businesses based on their operating and credit history. Under this model, the lender generally receives interest-only periodic payments until the date of maturity, at which point the business needs to repay the principal or refinance the debt.

Asset-backed lending is not dissimilar to direct lending, in that a non-bank lender provides capital to a business, but in this case, the funds are used to purchase a discrete asset capable of generating sustainable stream of cash flow. The businesses repay both principal and interest on a periodic basis, thereby amortizing the loan principal down more quickly than in the direct lending model. Chesswood Group Limited ("Chesswood"), a publicly traded specialty finance company, operates various subsidiaries that have a long history of primarily asset-backed leasing and lending.

The growth of private credit markets has been fueled by various factors, including increased regulatory requirements on traditional lenders, evolving market dynamics and the search for yield in a low-interest-rate environment.

According to market research firm Preqin Ltd., annualized estimates from October 2021 put private debt assets under management (AUM) near $1.21tn for year end. This is following a decade of growth, which averaged 13.5% annually, ahead of both private equity & venture capital (11.5%) and real estate (9.1%). Preqin forecasts that private debt will continue to grow, with AUM reaching $2.69tn by 2026, overtaking real estate, second in AUM only to private equity and venture capital by the close of 2023[1].

1. Preqin 2022 Global Private Debt Report



Source: Preqin 2023 Global Private Debt Report

Characteristics of Private Credit

Private credit investments possess distinctive characteristics that differentiate them from traditional fixed income instruments. These characteristics contribute to the benefits of investing in private credit and attract investors seeking diversification and downside protection.

Illiquidity Premium

Private credit investments typically exhibit illiquidity, which means that they are not easily traded on public (or private) markets. This illiquidity premium provides an opportunity for investors to capture potentially higher returns compared to more liquid investments. The illiquidity premium compensates investors for the limited ability to exit their positions quickly and underscores the long-term nature of private credit investing.

Priority of Claims and Structural Protections

In private credit, lenders often have seniority in the capital structure, providing a higher claim on the borrower's assets compared to equity holders. This seniority enhances the potential for principal preservation and recovery in the event of default or bankruptcy. Additionally, private credit investments may incorporate various structural protections, such as covenants, collateral and guarantees, further mitigating downside risk.

Yield Enhancement Potential

Private credit investments offer the potential for higher yields compared to public fixed income instruments due to factors such as illiquidity, credit risk premiums and complexity. The ability to access borrowers directly or through specialized funds allows investors to negotiate terms and capture attractive risk-adjusted returns.

Non-Correlation with Public Markets

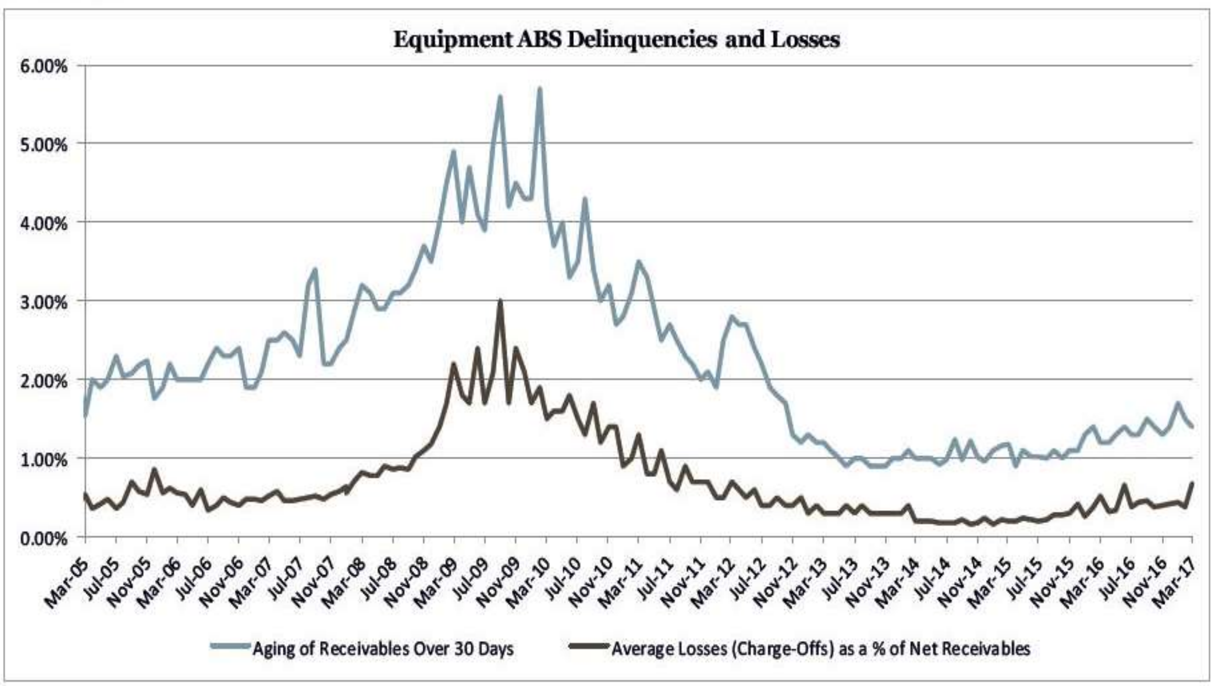
Private credit exhibits low correlation with public markets, including traditional fixed income and equity markets. This non-correlation provides diversification benefits to portfolios by reducing overall volatility and enhancing risk-adjusted returns. The performance of private credit investments is driven by different factors and dynamics, enabling them to act as a portfolio diversifier during periods of market turbulence.

Diversification Benefits

Private credit investments have gained popularity due to their ability to provide diversification benefits across various dimensions.

Counter-Cyclicality and Lower Volatility

Private credit has demonstrated counter-cyclicality, as it is less influenced by short-term market fluctuations compared to traditional asset classes. During economic downturns, private credit investments may exhibit lower default rates and recoveries than public market equivalents, thus preserving capital and providing a more stable income stream. This counter-cyclicality helps reduce overall portfolio volatility and can act as a buffer during market downturns. In the case of equipment leases and loans, this dynamic was witnessed during the GFC of 2007-2009 when Equipment ABS (Asset-Backed Securities) were one of the best performing asset classes, owing to the performance of the underlying securities comprising the ABS tranches. Losses in Equipment ABS peaked at about 300 basis points, nowhere close to materially affecting the cash flow performance of senior securities in ABS structures. "The non-existent prepayment risk, relatively short durations, low delinquency rates, low net losses and charge-offs for Equipment Lease ABS are primary explanations for experiencing the good performance during bad times"[2].



Source: Wells Fargo

Exposure to Non-Traditional Sectors and Geographies

Private credit provides access to non-traditional sectors, assets and geographies that are not readily available through public fixed income markets. Investors can allocate capital to niche industries, emerging markets or sectors with limited financing options. This exposure to non-traditional areas can enhance portfolio diversification and potentially capture higher risk-adjusted returns.

2. "Equipment Lease Securitization Performance Versus Other Asset Classes", Pepperdine University, 2011.

Complementing Traditional Fixed Income

Private credit investments can complement traditional fixed income allocations by offering higher yields, diversification and potential downside protection. The Sharpe ratio of private credit exceeds that of traditional fixed income (1.35 vs. 0.87)[3], indicating a better return per unit of risk, thereby effectively diversifying a traditional fixed income portfolio. By incorporating private credit alongside public fixed income investments, investors can enhance the risk-adjusted returns of their fixed income portfolios and navigate changing market conditions more effectively.

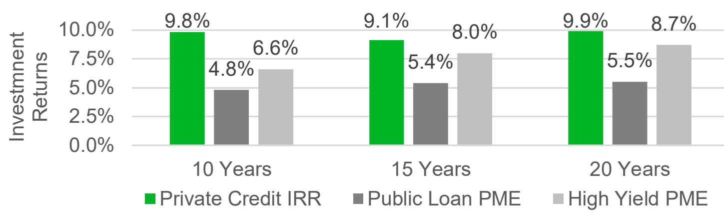
Risk-Adjusted Returns

Private credit investing offers potential risk-adjusted returns that are attractive compared to traditional fixed income investments.

Enhanced Risk-Adjusted Returns

Private credit investments have the potential to generate higher risk-adjusted returns compared to public fixed income securities. This is due to factors such as illiquidity premium, credit risk premiums and the ability to actively negotiate terms and underwrite credit otherwise overlooked by traditional financial institutions. The direct nature of private credit lending allows investors to capture additional yield and negotiate covenants that align with their risk appetite, potentially leading to superior risk-adjusted returns.

Private credit has outperformed Public Market Equivalents (PME) over the last 2 decades[4]:



Source: Goldman Sachs Asset Management, 2022

Principal Preservation

The structural protections embedded in private credit investments, such as seniority in the capital structure, collateralization and guarantees, contribute to the potential preservation of principal. These protections enhance the recovery prospects in the event of default, reducing the risk of capital loss.

Income Generation

Private credit investments typically generate attractive income streams in the form of interest payments. The higher yields associated with private credit can provide a stable and predictable income component to investors' portfolios. This income generation potential is particularly valuable in a low-yield environment, where traditional fixed income investments may struggle to meet income requirements. Investors need to remain wary of those private credit funds that accrue income but don't have corresponding cash flow. For example, some funds allow periodic interest payments owed by borrowers to the fund to be converted from cash to PIK (payment in kind). This typically occurs when the borrower isn't generating adequate cash flow to service the debt, a worrisome dynamic. PIK interest is simply accrued and added to the balance of the loan to be paid in future periods.

3. Comparison over 2011 – 2020; Traditional Fixed Income consists of 1/3 Barclays US Corporate Bond Index, 1/3 Barclays Canada Corporate Bond Index, 1/3 Barclays US Corporate High Yield Bond Index; Private Credit consists of 50% S&P LCD Leveraged Loan Index and 50% Cliffwater Direct Lending Index

Downside Protection

Private credit investments offer inherent downside protection features that can shield investors during challenging economic conditions.

Seniority in Capital Structure
Private credit lenders often have seniority over equity holders in the capital structure, providing a cushion against potential losses. In the event of default or bankruptcy, private credit investors have a higher claim on the borrower's assets, increasing the likelihood of recovering a portion of the investment.

Security through Collateralization
Many private credit investments are backed by collateral, such as real estate, equipment or intellectual property. This collateralization provides an additional layer of security, reducing the risk of loss and enhancing the recovery prospects in case of default. The ability to access tangible assets increases the confidence in the investment's downside protection.

Active Management and Due Diligence
Private credit investments often involve active management and extensive due diligence processes. Investment managers conduct rigorous credit analysis, assess borrower fundamentals and actively monitor the investments throughout the duration of the term of the loan. This active management approach helps mitigate risks and provides investors with a higher level of confidence in the downside protection of their investments.

Investment Strategies in Private Credit

Private credit encompasses various investment strategies, each with its own risk-return profile and target borrower segments. Direct lending, whereby loans are provided by non-bank entities based on operating cash flows of the business and general credit worthiness, is the largest segment of private credit. Asset-backed lending can also take many forms, including equipment leasing, auto lending and factoring, among others. Various types of private credit lending (direct and asset-backed) include:

Private Mortgages
A private mortgage, simply, is one underwritten by a non-bank entity. An alternative lender may provide a personal and commercial borrower more flexibility or expertise in certain market segments. In addition, consumers with a limited credit history, such as new immigrants, may choose a private mortgage. Private mortgages typically have higher mortgage rates and more non-standardized terms than traditional bank-underwritten mortgages.

Equipment Leases
Equipment leasing is a financing agreement in which business equipment is purchased by a leasing company (lessor) and rented back to the business owner (lessee) for a prearranged length of time at a flat monthly fee, which includes the return of both principal and interest each month. At the end of the lease term, the lessee would (a) own the underlying equipment, (b) trade up for a newer model or (c) close the lease by returning the equipment, assuming there is a residual buyout. Due to the underlying collateral and standardized legally enforceable contracts, equipment leasing has typically performed well over an investment cycle.

Auto Lending

Post the GFC, many banks and auto original equipment manufacturer (OEM) finance arms reduced their lending exposure to the market, forcing dealers to pursue other options. Furthermore, there are a considerable number of consumers that have sub-standard credit, eliminating the possibility of accessing bank or auto OEM credit. Private lending into the auto sector has several appealing attributes, including security against a hard asset with a resale value that can be estimated based on historical patterns. Lastly, many workers in North America require a vehicle to reach their place of employment, ensuring that maintaining payments is crucial.

Home Improvement

Many households do not have the requisite savings to fund substantive home improvement projects. Whereas many utilize the same bank that holds their first mortgage for a home equity line of credit (HELOC), this may not always be on offer to consumers. In addition, smaller dollar repairs/projects may not require the establishment of a HELOC, and with credit card financing rates at a premium, private credit fills this particular void.

Working Capital

With banks forced to maintain heady levels of reserves post the GFC, many small and mid-sized businesses are unable to access enough credit to properly fund working capital requirements (accounts receivable, inventory, etc.). Private credit solutions include factoring, whereby asset-backed lenders purchase customer invoices (as receivables) and rapidly provide needed cash back to the business. By purchasing the accounts receivable at a discount, the finance company earns this spread and associated fees.

Royalty/Revenue Financing

For creative industries, such as movies and music, the upfront cost of producing content is significant, with the payoff realized over the long life of a movie or the catalog of an artist. In the case of music, a lump sum can be provided to the artist in exchange for the future royalties associated with music sales/streaming royalties. In the case of revenue royalties, this relates more to the movie business, where private creditors aid in the upfront funding, but realize a set percentage of gross revenues from the subsequent release of the content.

Mid-Market Lending

For private mid-sized companies unable to access public bond markets and requiring more flexibility than banks can potentially offer, private credit has been filling this void. In some cases, private lenders are more willing to waive covenant breaches in times of stress. However, this may result in problems related to debt repayment at maturity.

Mezzanine Debt

Mezzanine debt investments sit between senior debt and equity in the capital structure. Mezzanine debt providers often receive higher interest rates and equity-like features, such as warrants or convertible options. Mezzanine debt offers the potential for higher returns while maintaining a level of security relative to equity holders, given the structural subordination.

Distressed Debt

Distressed debt investments involve purchasing debt securities of companies facing financial distress or restructuring. Distressed debt investors aim to capitalize on the potential recovery of troubled companies by acquiring their debt at discounted prices. Distressed debt strategies offer the potential for significant upside if successful turnaround or restructuring occurs, but significant risk if the troubled company fails to meet its debt obligations.

Litigation Debt
In many cases, the timing around litigation payoffs can be uncertain, owing to the latency inherent in the court system. Litigation finance provides capital to plaintiffs and lawyers in exchange for repayment with a lending premium once the case is settled. The inherent risk to the financier involves losing the case, in which case a loss is realized. Due to this risk, the rates charged by the financier are typically at a premium.

Special Situations
Special situations strategies encompass a wide range of investments, including event-driven opportunities, structured credit and non-traditional lending. These strategies target unique situations, such as merger and acquisition financing, project finance or financing for growth initiatives. Special situations investing offers the potential for higher returns by capturing value from specific market events or transactions.

Market Dynamics and Opportunities

The private credit market has experienced significant growth in recent years, driven by various factors that create attractive investment opportunities.

Increased Demand for Private Credit
Private credit has witnessed increased demand from institutional investors seeking to diversify their portfolios and capture yield in a low-interest rate environment. Traditional lenders, such as banks, have faced stricter regulatory requirements, leading to a reduction in their lending activities. This has created a funding gap that private credit can fill, providing alternative financing solutions for companies and projects.

Favourable Market Conditions
The current market environment has been conducive to private credit investing. Low-interest rate environments, coupled with strong credit fundamentals, created favourable conditions for private credit investments. These conditions enabled investors to capture attractive risk-adjusted returns and capitalize on the demand for financing in various sectors. While interest rates have risen materially over the past year, the rates at which private credit is being underwritten have also moved higher, ensuring a considerable spread over public market options.

Access to Non-Sponsored Deals
Private credit investors often have access to non-sponsored deals, where the borrower does not have private equity backing. These non-sponsored deals can offer attractive risk-return profiles, as they may have less competition from traditional lenders and private equity firms. Non-sponsored deals allow investors to deploy capital in companies that have strong fundamentals but may not attract attention from other sources of financing.

Relationship-Driven Investing
Private credit investments often rely on relationship-driven investing, where investors establish long-term partnerships with borrowers and develop a deep understanding of their businesses. This relationship-driven approach allows investors to gain unique insights, negotiate favourable

terms and participate in repeat investment opportunities. It fosters collaboration between investors and borrowers, enhancing the potential for successful outcomes. In the case of Chesswood, our US subsidiary Pawnee Leasing has been in the equipment leasing industry for over 40 years, weathering multiple economic cycles and building proprietary knowledge surrounding many target market sectors.

Challenges and Considerations

While private credit investing offers compelling benefits, it is important for investors to consider and address several challenges and considerations.

Credit Risk of Underlying Obligor
One of the main risks of private credit investing is the credit risk of the underlying obligors and associated leases / loans. This is the risk associated with the ability of the borrowers to repay their loan or lease. It is important for investors to understand the risk profile of the underlying obligors and ensure it aligns with their risk profile.

Illiquidity and Lock-Up Periods
Many private credit investments are characterized by their illiquid nature, meaning that they are not easily bought or sold on public exchanges. Investors face lock-up periods, where their capital is committed for an extended period without the ability to access it. This illiquidity can limit an investor's ability to respond to changing circumstances or liquidity needs.

Due Diligence and Manager Selection
Due diligence is critical when investing in private credit. Investors should carefully assess the track record and capabilities of investment managers or platforms. Thorough credit analysis, risk assessment and underwriting processes are essential to evaluate the quality of investments. Selecting experienced managers with robust due diligence processes can mitigate risks and enhance the potential for successful outcomes.

Opaque Nature of Credit
Due to the non-public nature of the underwritten credit, it may be difficult to obtain complete information of the underlying assets, which is typically easily accessible in public investments.

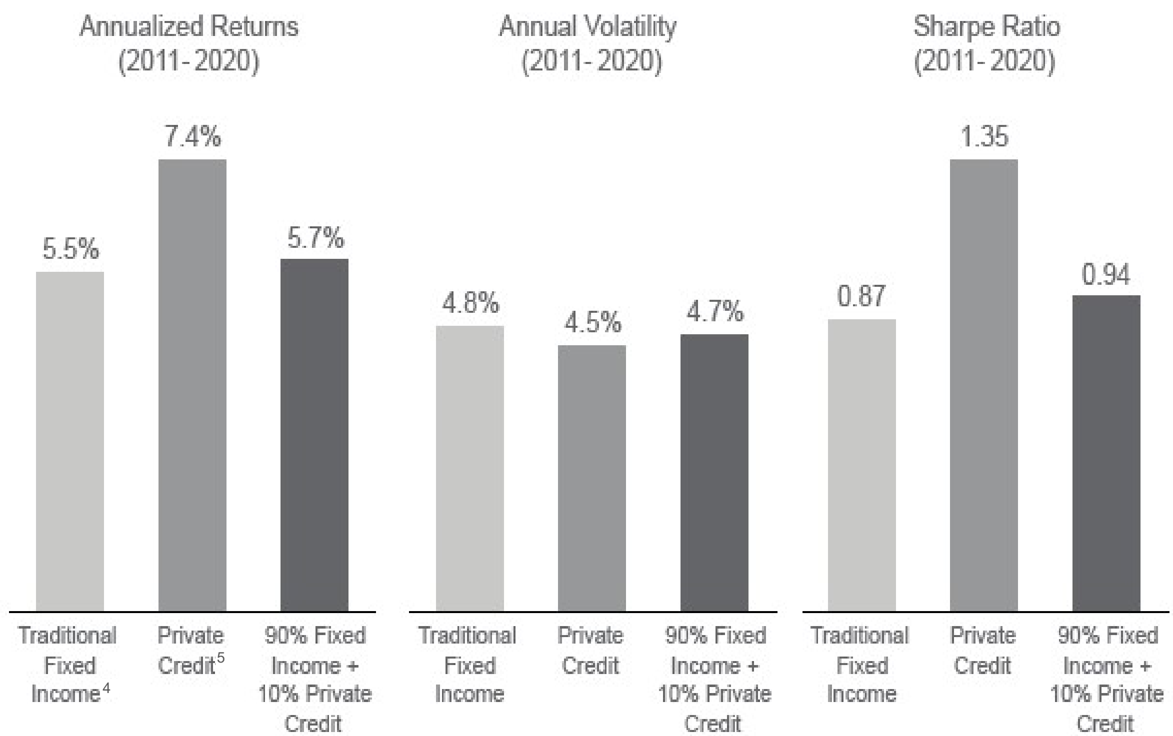
Portfolio Implementation and Allocation

To effectively implement private credit investments in a portfolio, investors should consider various factors and align them with their investment objectives and risk tolerance.

Portfolio Construction Considerations
Investors should assess their overall portfolio allocation and consider the role of private credit within the broader investment strategy. Private credit can be considered as a fixed income substitute, an alternative to traditional fixed income or as a separate asset class within a diversified portfolio. The allocation decision should consider risk-return objectives, investment horizons and liquidity requirements.

Combining Private Credit with Other Asset Classes
Private credit investments can complement other asset classes within a portfolio, such as equities, fixed income or alternative investments. Combining private credit with other assets can enhance diversification benefits, improve risk-adjusted returns and reduce overall portfolio volatility. A diversified portfolio across multiple asset classes can help achieve a more balanced risk-return profile.

Returns, Volatility and Sharpe Ratio



Source: Institutional Investor, July 13, 2021

Assessing Risk and Return Profiles
Investors should carefully assess the risk and return profiles of private credit investments. Factors such as credit risk, duration, illiquidity and potential loss severity should be evaluated. Understanding the risk-reward trade-off is crucial in aligning private credit investments with investors' risk tolerances, income requirements and long-term investment objectives.

Conclusion

Private credit investing offers compelling benefits to investors seeking attractive risk-adjusted returns, diversification and downside protection. The characteristics of private credit, such as illiquidity premiums, priority of claims and yield enhancement potential, make it a valuable addition to investment portfolios. By carefully considering investment strategies, market dynamics, and implementation considerations, investors can harness the benefits of private credit and enhance their long-term investment outcomes.

4. 5. 1/3 Barclays US Corporate Bond Index, 1/3 Barclays Canada Corporate Bond Index, 1/3 Barclays US Corporate High Yield Bond Index
5. 50% S&P LCD Leveraged Loan Index, 50% Cliffwater Direct Lending Index

Due to the cadence of principal and interest repayment, our strategies have revolved around asset-backed lending within the private credit segment. We believe the rapidly amortizing loans, coupled with the underlying collateral and above average yields will drive substantive growth for this segment of private credit over the next several years.

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