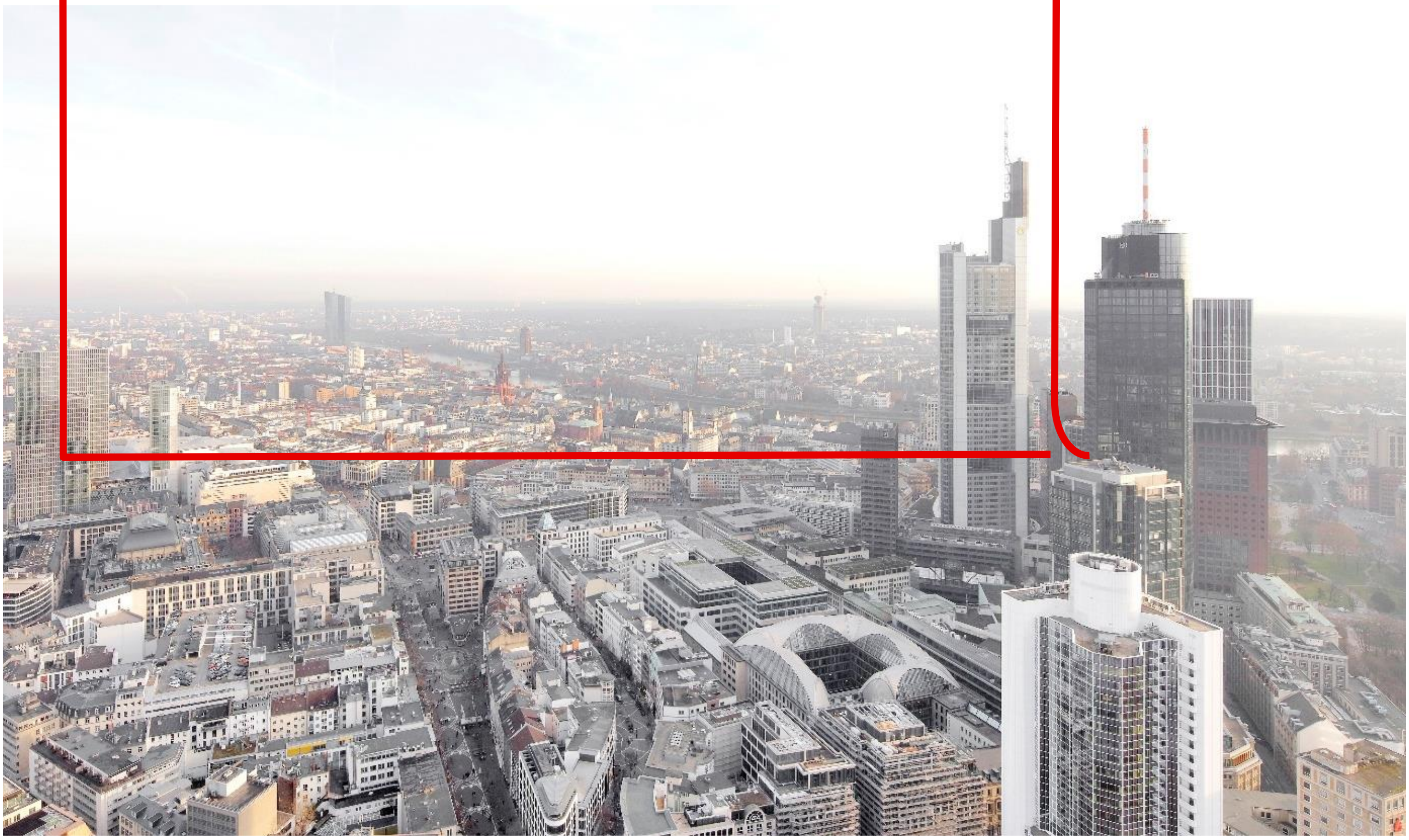
UBS Asset Management

Not as you know it.

An introduction to Private Credit



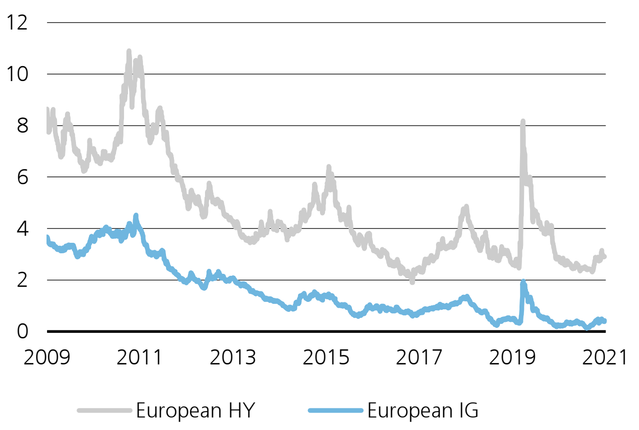
What is private credit?

Private credit strategies can provide investors with the opportunity to outperform traditional credit markets whilst maintaining a stable income base.

Market opportunity
The present market environment represents a highly challenging landscape for income-seeking investors. With the traditional market trading at or near historically low yields and an increasingly volatile macro backdrop, investors have been searching for alternative options for yields.

European debt yields have reduced significantly for both IG and HY since the financial crisis (see Figure 1).

Figure 1: European Debt: HY and IG Yields (%)



Source: Data adapted from Bloomberg, Barclays, LCD 2020 Mid-Market

Investors are increasingly concerned about inflation and rising interest rates, and are looking for some form of yield to bolster portfolios. This need is exasperated by the pandemic induced volatility of the stock and bond markets.

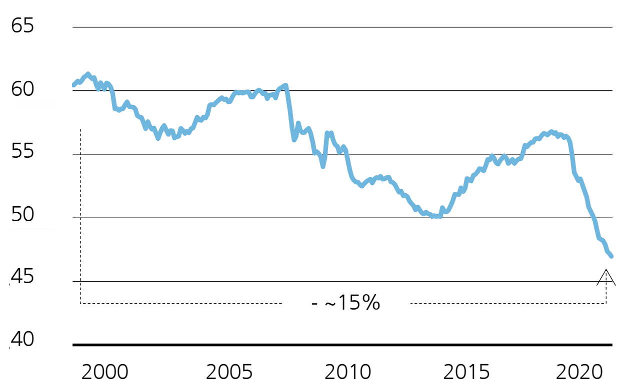
For an ever-increasing number of investors, this search leads them to the world of private credit. Thus, the strategy has become a fast-growing area of finance and the focus of asset managers globally.

Private credit
Private credit, also known as private debt, refers to non-bank lending that is not regularly traded on public markets. Given the private nature of most asset classes within private credit, the strategy and ultimate returns are primarily impacted by the economy and changes to the credit cycle, as opposed to the market volatility observed with tradable assets. However, there are nuances to the premium investors are earning that make sector, strategy and asset selection important drivers of results. Additionally, the execution of these strategies is very different from traditional credit markets. Sourcing, underwriting and asset management make up the three-legged stool that determines a portfolio's outcome.

When most investors consider private credit, they tend to think of closed-end funds with a 5-10-year time frame that invests in the corporate credit sector, employing either a direct lending or distressed strategy. However, the world of credit is considerably deeper than these strategies and it is access to this broader universe that provides investors with a more robust return profile.

Credit markets are made up of securities and loans that sit along a continuum of liquidity – from directly originated (bilateral) to broadly syndicated. After the global financial crisis, new regulation forced financial institutions to retrench their footprint in credit markets. As banks and insurance companies pulled back, private capital emerged to fill in the gaps. This process continues today.

Figure 2: Commercial Loans (% proportion of commercial and industrial loans relative to total assets for US commercial banks)



Source: Federal Reserve Data 2021 – not seasonally adjusted

Terms

Direct lending
A private fund is engaged in a bilateral negotiation with a company to provide some kind of debt instrument, either senior or mezzanine, for that company. It can be syndicated or direct origination.

Distressed investing
A private fund that invests in public or private debt of a bankrupt company. The manager, or a consortium of investors, restructure the company creating a new capital stack. Often the fund will receive equity in the company, called reorganized equity, and a new piece of debt. As the company recovers, the credit is repaired and the distressed investors look to exit. This strategy can be executed across a range of controls, from passive to active to distressed-for-control.

Sectors

Specialty lending
- Transportation (e.g. aircraft, shipping, etc.)
- Consumer
- Trade finance
- Small businesses / venture

Structured credit
- Collateralized loan obligation (CLO)
- Commercial mortgage-backed security (CMBS)

Real estate debt
- Residential
- Commercial

Private credit as a portfolio tool

Private credit can offer two types of exposure to a portfolio: yield and total return. Regardless of the type of exposure, the objective of private credit is to provide a higher return at a comparable or lower level of risk relative to the public credit markets. Within Private Credit there are multiple investment strategies of note with varying yield, total return and duration. Four of the most popular are: core income, short duration, opportunistic and hybrid.

Core income
Core income strategies provide stable returns for investors primarily from cash flow. These strategies tend to focus on originated par loans that have low volatility and correlation to traditional credit markets. This strategy can be executed across credit sectors.

Short duration
Short duration strategies are core income-oriented strategies that have a weighted average life of less than 2 years. These bridge lending strategies tend to be focused on asset backed and real estate sectors. Given the focus on cash flow and the shorter duration nature of the underlying debt, these strategies tend to have low volatility and correlation to traditional credit markets.

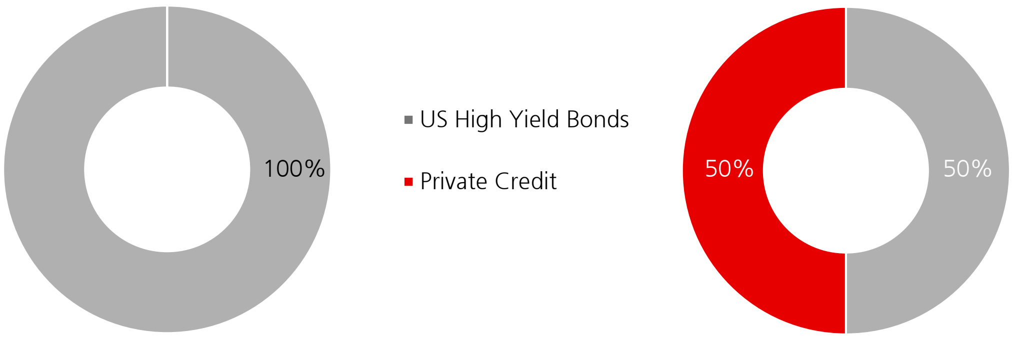
Opportunistic
Opportunistic credit strategies drive return from a mix of total return and cash flows. These strategies are higher returning and can come with more volatility but can be very additive to a portfolio over time. Many of these strategies can be cyclical in nature with large swings in market opportunities. This makes timing especially important. Skilful allocators that go against the pack can be liquidity providers to markets at times of stress and can earn very attractive risk-adjusted returns.

Hybrid
Hybrid strategies combine the stable cash flows of lending strategies with equity participation. This can be through a private convertible bond, a direct origination loan with warrants or a preferred equity position. These strategies are generally employed in higher growth sectors such as technology, healthcare and financial services. Strategies can focus on companies at various stages from venture to pre-IPO to mature companies seeking capital in order to grow. Given the equity participation, these strategies tend to have a higher return and a higher volatility profile.

The breadth and depth of investment strategies makes private credit a unique tool that can provide a variety of solutions depending on the client needs. Portfolios are designed based on return targets, cash flow needs, risk tolerance, beta/volatility sensitivity, ESG requirements, and regulatory restrictions.

Portfolio comparison

Base case | **Including private credit**



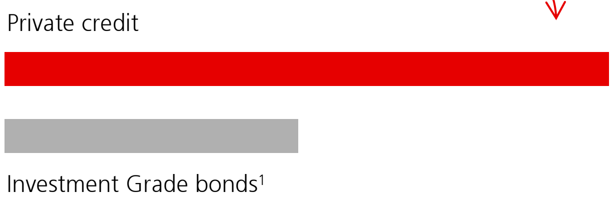
7% annual return

10.8% annual volatility

8.4% annual return

6.4% annual volatility

>2x Outperformance to IG debt



Lower Correlation

Lower std. Deviation

Source: UBS Asset Management, Real Estate & Private Markets (REPM); December 2021. Target returns presented herein do not constitute a forecast of future returns. Portfolio HY data from BoA US High Yield Index. Private Credit data from the Cliffwater Direct Lending Index. Comparison performed 2005-2021. Note 1: Bloomberg US Aggregate Bond Index (2005-2021)

Risk and reward

The goal is to source and exploit the most attractive yield per unit of credit risk. However, the complexity of comparing these strategies requires sophistication and experience. As such, most investors diversify for diversification's sake. Selecting sectors to focus on and areas to eliminate can be a substantial differentiator in long-term performance.

Yield strategies typically don't pose a substantial risk of permanent loss. Whilst investors should evaluate credit risk, or cliff risk (the scenario where the asset value falls off a cliff), extension of credit is the more common issue. Credit extension happens when an asset (i.e. company, building, consumer, etc.) has difficulties repaying a loan and needs to extend repayment of capital, delaying income generation. Credit extension can dilute yields leading to disappointing results and unexpected illiquidity.

Outside of the yield of a particular loan or strategy, there are several other drivers of risk/return to focus on when underwriting a potential investment:

Operating profile of the asset
Transitional vs. stabilized vs. distressed

Credit profile of the asset
Historical asset volatility, default and severity rates

Capital structure
Seniority and covenant

Leverage
Quantity, costs and terms

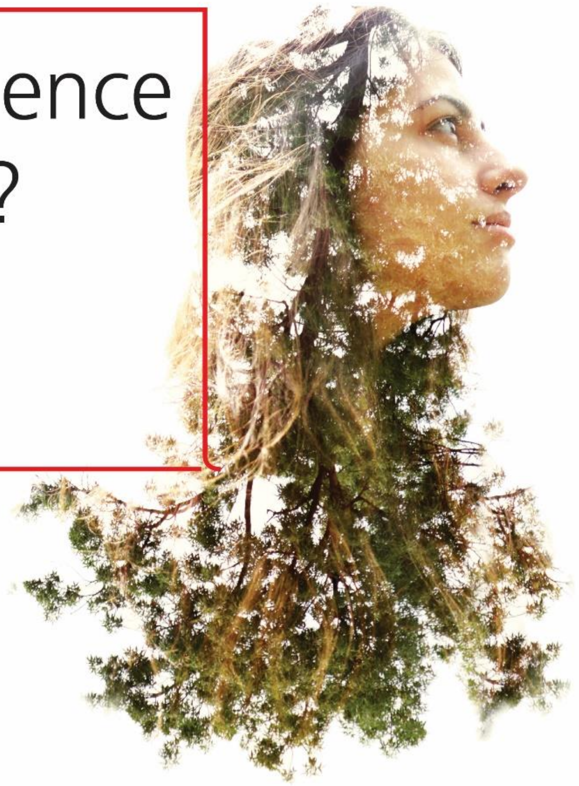
More opportunistic strategies such as distressed typically provide higher returns, but also come with higher inherent risks. This is due to assets requiring some form of turn around which introduces timing risk. Like yield-oriented strategies, investors try to get out of making difficult choices and diversify, but this time through vintage. The argument is if every vintage is invested in, the good ones will ultimately be caught. This is a recipe for average results.

The outlook

Private credit emerged from the global financial crisis as a result of regulatory changes. It has been driven by investors searching for yield in a historically low yield environment.

However, most investors have a narrow view and a lack of experience and scale to effectively navigate the broad credit landscape.

Private credit strategies can substantially improve client outcomes if utilized properly.



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