

UNDERSTANDING PRIVATE DEBT

INVESTING IN PRIVATE MARKETS

INTRODUCTION

Private debt, also known as private credit, is a type of financing where companies borrow money from funds and investors instead of banks. It usually involves unlisted debt securities with fixed or floating interest rates. Companies use private debt for various needs, like funding projects, business growth, or deals like mergers and acquisitions. It offers tailored solutions and flexibility compared to traditional financing. As banks continue to reduce their credit book volume, private debt funds become more and more important.

The private debt market has experienced significant growth over the past decade, establishing itself as a prominent asset class within the alternative investment landscape.

As of early 2024, the global private debt market was estimated at approximately \$1.5 trillion, up from around \$1 trillion in 2020 and BlackRock forecasts the global private debt market to attain \$3.5 trillion in assets under management by the end of 2028¹.

PRIVATE DEBT'S ROLE IN A PORTFOLIO

Private credit plays a crucial role in enhancing portfolio diversification and income generation. As an alternative asset class, it offers low correlation with public equities and bonds, helping to reduce overall portfolio volatility. The steady income from private credit, driven by interest payments on loans, provides a reliable cash flow.

In a broader portfolio, private credit can act as a stabiliser, offering predictable returns with relatively lower risk when invested in senior secured loans or direct lending strategies. For investors willing to take on higher risk, segments like mezzanine or distressed debt offer opportunities for higher returns. Overall, private credit complements traditional investments, improving risk-adjusted returns and aligning well with long-term investment objectives.

KEY FEATURES OF PRIVATE DEBT

Non-bank lending: Private debt is provided by non-bank lenders, which are typically institutional investors.

Flexible terms: Private debt offers more flexibility in terms of loan covenants, maturity dates, and interest rates compared to traditional bank loans. This allows borrowers to tailor the financing to better suit their specific needs.

Relationship-based approach: Private debt lenders often take a hands-on, relationship-based approach when working with borrowers granting access to industry expertise and guidance beyond just the capital provided.

Stability and predictability: Private debt often offers stable and predictable cash flows for both borrowers and lenders, as repayment terms and interest rates are agreed upon upfront.

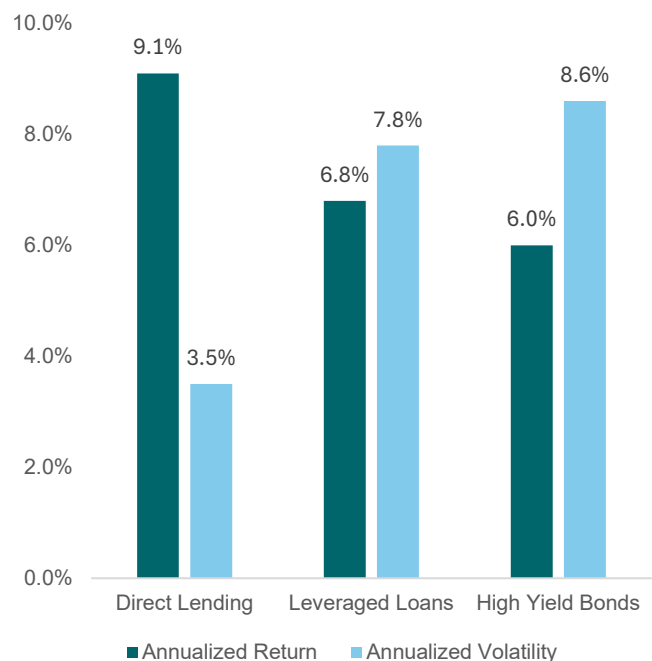


Figure 1: Forecasted 10-year annualised risk-return for public and private credit (%) ². Past performance is not a reliable indicator of future performance.

¹ Source: Blackrock "Private Debt. The Multi-faceted growth drivers", September 2024

² Source: iCapital, Q4 2024. Forecasts are not a reliable indicator of future performance.

DEBT CAPITAL STRUCTURE

In the private credit market, companies use different types of debt along with equity to raise capital. Not all loans are the same and in case of a default, there will be some ranking in terms of investor protection. Each type of loan has its own balance of risk and return depending on its position in the capital structure.

As a risk adverse investor, one would like to be at the top of the capital structure, in senior debt, which is the safest as it offers the most protection but with lower returns. As you move further down, to junior or subordinated debt, the risks increase but the potential returns increase. Mezzanine debt is even riskier with higher returns, and often contains some equity element. Overall, all debt types take priority over common equity should the company default.

Senior debt

- A loan that has to be repaid first if the borrower defaults with a clear priority over more junior debt within the capital structure.
- Typically secured by collateral or assets over which the lender has 'first lien' (first claim).
- Less risky than more junior debt or equity.
- The interest rate charged by the lender is often lower than for junior or subordinated debt.

Subordinated debt

- Also called junior debt, it is repaid after the senior debt in the event of a default.
- More risky than senior debt and pays a higher interest rate.

Mezzanine debt

- Also called hybrid, because it is a combination of debt and equity - subordinated debt, that can be converted into equity in the event of a default.
- Contains 'embedded equity options' or 'kickers' such as stock call options, rights, or warrants.
- Senior only to common shares and equity in the capital structure.
- Unsecured debt issued without collateral, therefore demanding a high interest rate.

DIFFERENT TYPES OF DEBT AND ASSOCIATED RISKS

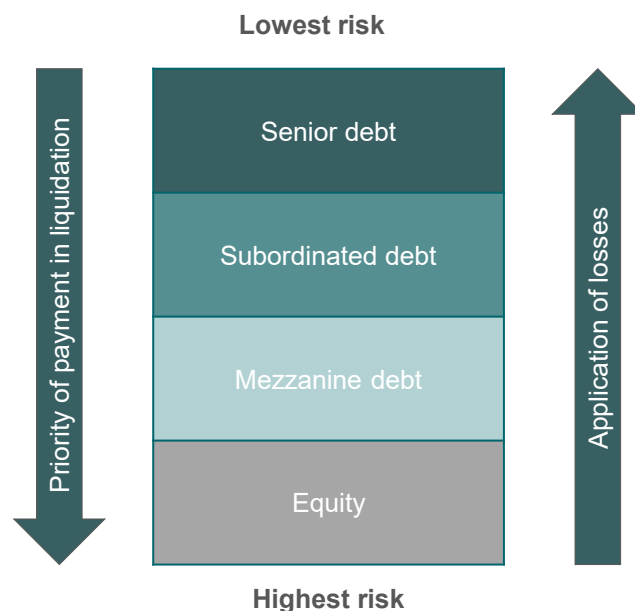
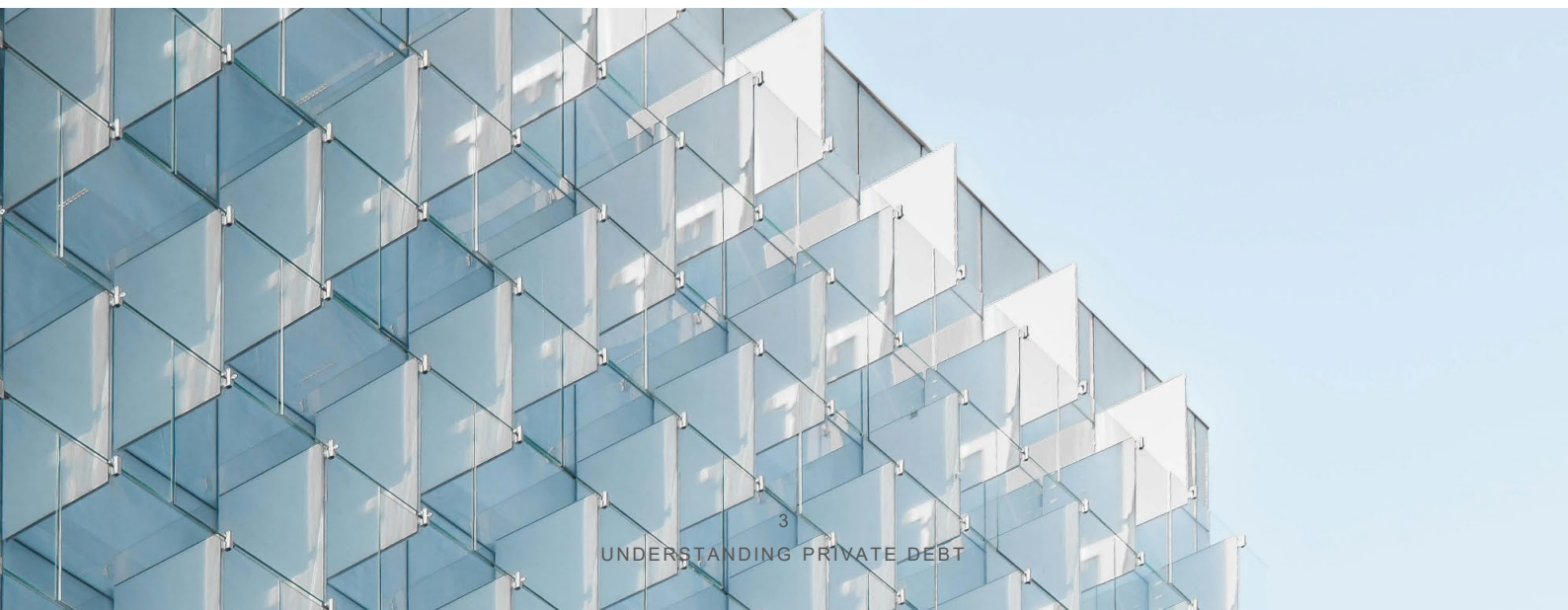


Figure 2: For illustrative purposes only.



PRIVATE DEBT STRATEGIES

Diverse strategies cater to a wide range of investors, each offering a unique risk-return profile and role within a diversified portfolio.

- **Direct lending:** companies directly borrowing from a private debt fund instead of borrowing from a bank or through bonds on the capital markets.
- **Mezzanine debt:** typically refers to a hybrid form of financing that combines elements of debt and equity. Mezzanine financing is often used in private markets to fund leveraged buyouts, acquisitions, or growth capital for companies and demands higher returns.
- **Distressed debt:** a private debt fund lending to companies which are either in default, bankruptcy, high risk of entering bankruptcy; or a private debt fund buying debt of such companies at a considerable discount. The goal is to benefit from the potential improvement of a company's financial health which would secure debt payments and increase the value of the debt.
- **Special situations:** lending to companies in a special situation, like a merger, an acquisition or a control investment in over-leveraged companies through debt ownership.
- **Asset based financing:** project lending e.g. infrastructure or real estate debt financing.

PRIVATE DEBT ACCESS FOR INVESTORS

Investors can access private debt through closed ended, non-listed private debt funds, fund of funds or evergreen open-ended private debt funds that offer certain liquidity options.

The evergreen structures provide ongoing access to private debt, allowing periodic subscriptions and redemptions with no fixed end date. Capital from repaid loans is reinvested, offering continuous exposure to the asset class and steady income streams, making them particularly attractive for individual investors or in discretionary portfolio management.

These funds simplify access to private debt by removing complex drawdown processes and lowering minimum investments. Strategies typically include direct lending, real estate debt, and infrastructure debt, offering diversification and low correlation with public markets.

Direct lending	Mezzanine	Distressed/Special sits	Asset based Financing (Real Estate and Infrastructure)
Steady income stream and high visibility of cash flows	Combines debt-like income with equity-like returns	High returns through debt restructuring, asset sales, or equity conversions	Asset-backed security and diversification into real assets, long duration and stable income



RISKS AND CONSIDERATIONS

While private credit offers attractive returns and portfolio diversification, it comes with a range of risks that investors should carefully consider:

- **Credit Risk:** The primary risk in private credit is the potential for borrower defaults. Since many borrowers in this market are mid-market companies, there is a heightened risk of financial difficulties that may lead to late payments, restructuring, or outright default.
- **Illiquidity Risk:** Private credit investments are typically long-term and not easily tradable in secondary markets. Investors may face challenges in exiting their positions, especially during periods of market stress or if liquidity is required unexpectedly. Even in evergreen structures that allow periodic redemptions, gating mechanisms can limit liquidity during periods of high redemption demand, leaving investors unable to access their capital when needed.
- **Valuation Risk:** Unlike public bonds, private loans are not frequently traded, making their valuations less transparent. Fund managers often rely on internal or third-party assessments, which may not fully reflect current market conditions.
- **Interest Rate Risk:** While many private credit instruments are floating-rate and can benefit from rising rates, some fixed-rate instruments may lose value as interest rates increase.
- **Economic and Market Risk:** Private credit performance is closely tied to economic conditions. During a downturn, borrowers may struggle to meet their obligations, leading to higher default rates and losses for investors.
- **Operational and Structural Risks:** Investing in private credit often involves reliance on the expertise of fund managers. Choosing a strong manager is key to mitigate poor underwriting, lack of diversification, or inadequate monitoring of loans that could significantly impact returns.

Investors should mitigate these risks through thorough due diligence, diversification, and selecting experienced fund managers with a proven track record in credit underwriting and portfolio management. Understanding these risks is essential to aligning private credit investments with broader financial goals.

CONCLUSION

Each of the private debt strategies' risk/return profiles are dictated by the investment and its position within the capital structure. Strategies with lower risk tend to yield lower returns than those with higher risk. Unlisted private debt funds offer attractive risk-adjusted returns with an illiquidity premium.

- Banks continue to reduce their lending with increased pressure through regulatory capital requirements with this financing gap providing opportunity for private debt funds.
- Private debt offers a diverse range of risk profiles, maturity profiles and sector exposures which allows managers to build a portfolio that can earn attractive inflation adjusted returns with stable cash flows.
- With a lower beta to overall markets than bonds and lower volatility, private debt provides a good portfolio diversification.
- The flexible terms and floating interest rates help investors to protect against rising rates in the future.
- A private debt portfolio can offer the following attractive characteristics for investors:
 - Alternative to fixed income investments
 - Portfolio diversification
 - Low correlation to public markets
 - Attractive risk-adjusted returns
 - Predictable and contractual returns based on interest rate charged
 - Lower risk than private equity, cause debt ranks higher than equity in the capital structure.

However, investors should be aware that private debt carries risks, including credit risk, liquidity constraints, and potential interest rate fluctuations, which can impact returns.

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