IS PRIVATE CREDIT THE ANTIDOTE FOR WHAT AILS FIXED INCOME?

A PERFECT STORM FOR BOND INVESTORS

Fixed income investors have benefited from a secular decline in rates since the 1980s, seeing appreciation in the value of their bonds on an almost annual basis. At the same time, they have also had to contend with reinvestment risk – that is, the risk that one cannot reinvest interest and principal payments at the formerly available rate.

For those investors looking to fixed income to meet future expenses, this reinvestment risk, along with perpetually lower interest rates, means that maintaining consistent cash flow has been a daunting challenge. Many investors have adopted to a “total return spending policy” - essentially spending capital gains, along with interest and dividends. This has worked, but it lacked the predictability that was historically provided by the interest payments from corporate or municipal bond portfolios.

Now, we’re “playing the record backwards” with rising rates causing losses in investors’ bond portfolios. When coupled with heightened stock market volatility, you have a recipe for investor anxiety. Enter “private credit” as a possible investment option.

WHAT IS PRIVATE CREDIT?

Most investors are unfamiliar with the characteristics of private credit investments, but at its core, this asset class might be best described as “direct lending”. While large corporations can access the bond markets by issuing fixed income instruments though investment banks, mid-sized companies lack that access.

There are more than 350,000 middle market companies in the U.S., accounting for some 33% of U.S. GDP.[1] Yet, middle market borrowers often find commercial banks unable to effectively serve their needs. The Dodd-Frank Act enacted after the 2008-2009 financial crisis severely limited banks’ ability to lend to such borrowers. Middle market companies increasingly find better and more flexible terms from the private lending community that emerged to fill this gap.

PRIVATE CREDIT – WHY NOW?

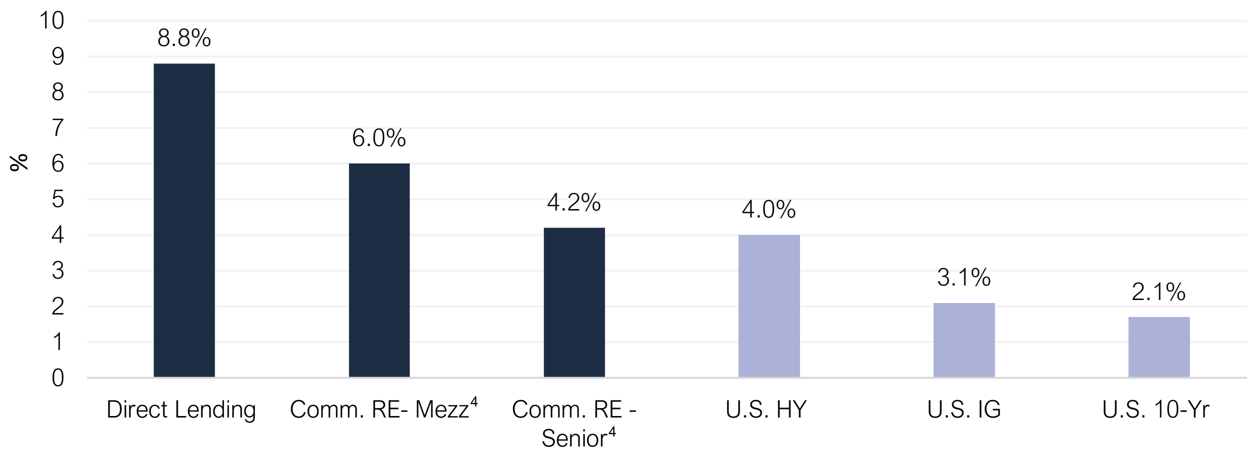
From the portfolio investor perspective, private credit provides many attributes that are particularly attractive in the current environment. While interest rates paid today by large corporate entities are attractive to the borrower, they leave a bit to be desired for the investor. Despite the recent rise in interest rates, AA-rated corporations can often borrow for ten years at just over 2.5%.[2] Even “high yield” debt is yielding less than 5.5%.[3] These instruments carry fixed rates, meaning that a continued rise in rates will subject the investor to capital losses, and relative to recent rates of inflation, their yields aren’t particularly attractive.

Contrast that with private credit. Private debt transactions tend to be shorter term (typically about five years) and at floating rates based on a benchmark such as LIBOR. A rise in short-term interest rates would result in a commensurate rise in the interest paid to the investor without change in principal value. Like all debt instruments, rates on private credit vary by the credit quality of the borrower, terms of the loans, etc., but in general, private credit funds offer a 6% to 7% increase in yield versus investment grade corporate debt.

[1]Bridging the Gap Between Capital Providers and Midsize Companies, hbr.org, Mach 23, 2021. [2]ICE BofA AA US Corporate Index Effective Yield, FRED, March 4, 2022. [3]ICE BofA US High Yield Index Effective Yield , FRED, March 4, 2022.

Mid-sized private companies would not have their loans "rated" by a Moody's or Standard & Poor, making the acumen of the lender among the most important investor criteria. Middle market borrowers should pay higher rates than an AA-rated corporation, but as Exhibit 1 shows, for investors willing to tolerate the added credit risk and illiquidity, the yields are substantially higher than are available elsewhere. Importantly, privately structured deals may also include equity warrants as part of the lending package, meaning that investors participate in the future prosperity of the enterprise via equity ownership.

Exhibit 1: Fixed Income Yields



Source: JP Morgan Asset Management Private Credit Outlook as of 1/12/22.

WHAT ARE THE RISKS WITH PRIVATE CREDIT?

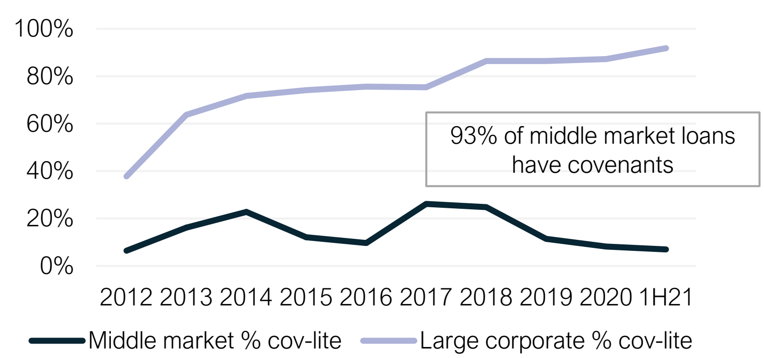
Investors may wonder how private credit will perform in the next economic downturn, or if rates were to rise rapidly. What about a private credit fund makes it more or less risky than other fixed income investments?

In contrast with a bond mutual fund, private credit funds have far fewer borrowers. All things equal, concentration adds risk. While a bond fund may have hundreds, or thousands of positions, a private credit fund may have a few dozen. This more concentrated portfolio means that each borrower is important to the health of the fund. In this regard, private credit funds look a lot like private equity, with emphasis on structuring each deal to meet the specific needs of the borrower and the fund.

As JPMorgan points out in their Private Credit Outlook (Exhibit 2), terms and covenants are loosening at the larger end of the borrower spectrum, but not in the lower market. This further reinforces Altera's focus on the lower middle market where spreads remain attractive, and terms are still risk conscious.

While these factors indicate that it is still a robust environment for private lending, it is difficult to

Exhibit 2: Private Credit Covenants Remain Firm at Lower End



Source: S&P LCD Quarterly Leverage Lending Review (data as of 6/30/21) and U.S. Middle Market Stats Historical (data as of 9/30/21).

[4]Commercial real estate (CRE) yields are as of September 30, 2021. CRE – mezzanine yield is derived from a J.P. Morgan survey and U.S. Treasuries of a similar duration. CRE – senior yield is sourced from the Gilberto-Levy Performance Aggregate Index (unlevered).

predict with certainty how the asset class will perform in the next economic downturn. The case of borrower and lender action in the COVID-19 environment provides some insight.

In the article “More Borrowers Turn To Private Markets for Credit”, *The Economist* states that “The big private-market players were, if anything, a stabilizing influence: Many stayed in the game even as liquid markets briefly seized up. Few were forced sellers.” They quote one market participant as saying, “Private-credit funds and private-equity owners did a lot of bespoke rescue financing and other patching up, often in tandem.” As a result, private credit funds tended to effectively manage the difficulties facing their borrowers, emerging largely intact on the other side.

Altera has seen firsthand the cooperation between borrowers and private lenders. Surely out of necessity, private lenders wished for their borrowers to thrive. They worked with portfolio companies that were having difficulty, monitoring their operations on a weekly basis, helping them to apply for PPP loans, and often renegotiating terms. New loan terms resulted in additional fees to the lender but gave their borrowers room to improve their operations. Managing each relationship for mutual benefit appeared to be the objective through the COVID-19 downturn.

What emerges for the investor is a picture of bespoke lending that meets the needs of the borrower and the lender. While not without risk, the illiquidity of the private credit asset class makes it more akin to “patient capital” than it is like investing marketable securities. Private credit managers need to be partners with their portfolio companies. Bond fund managers generally have no relationship with the issuers, and when bond fund investors are quick to sell, they essentially force these managers to liquidate positions at unfavorable times.

The ”unrated” nature of private credit means that investors should look first to the fund sponsor for a verifiable track record showing their acumen in assessing credit risk. Then, for investors who can tolerate the illiquidity and more concentrated portfolio of a private credit fund, the premium yield and decreased interest rate risk is theirs to harvest.