



Private Credit – Challenges & Opportunities

October 2024

What is Private Credit

“...privately negotiated [credit] transactions...”

“...any loan of private placement, bond origination that is not the product of a syndicated process...”

“...it’s held by locked up vehicles. It’s not liquid. You can’t trade it. You buy it, you own it...”

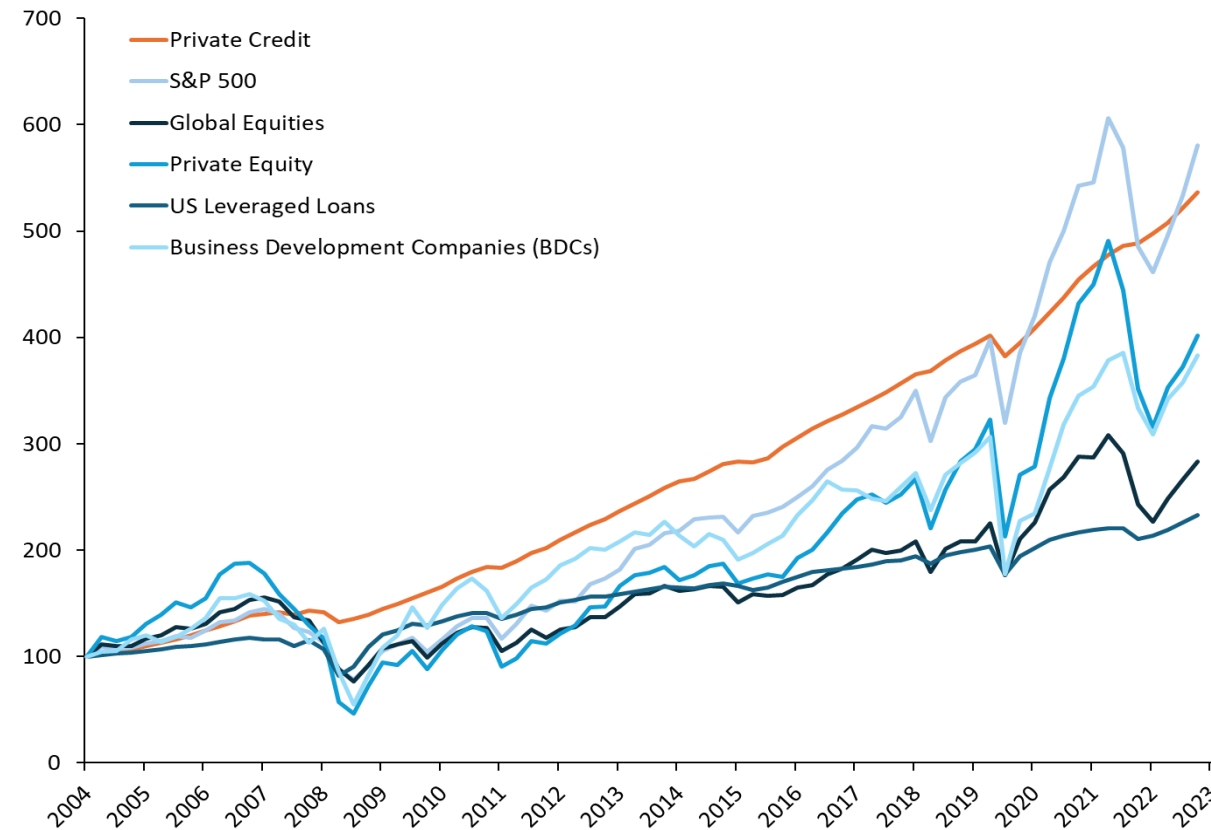
“...debt-like, non-publicly traded instruments provided by non-bank entities, such as private credit funds or BDCs...”

“...an investment strategy that is not homogenous and which consists of making privately negotiated loans to companies...”

Meteoric Rise of Private Credit

- Over the past two decades, private credit has expanded from a \$50 billion market to a \$1.7 trillion market, exceeding those of leveraged loans (\$1.4 trillion) and high-yield bonds (\$1.3 trillion).
- Historically, private credit returns have rivaled and even outperformed some better-known alternatives, including the S&P500 and MSCI World Total Return indices, through periods including recessions.

Return on Private Equity, Private Credit, and Other Asset Classes



Despite rapid growth, the private credit market remains largely opaque to investors.

Challenges Faced by Private Credit – Mark to Model

Unrated, rarely traded, and without standardized contract terms, these loans are often valued based on asset managers’ internal models. Some critics have derisively labeled this process as “marking to magic.”

- We analyzed the fair value marks on 34 loan investments held by two or more of the 20 largest business development companies (“BDCs”).
- For 4 loans, mark discrepancies range from 3 to 9.3 percentage points – mark discrepancies tend to be larger when the loan price drops well below par.

Examples of Private Credit Asset Valuation Challenges

Hertz Facility

Hertz’s 2020 bankruptcy involved complex negotiations with creditors over collateral valuation within private credit portfolios during restructuring.

Neiman Marcus Bankruptcy

Neiman Marcus’ bankruptcy in 2020 involved significant challenges in asset valuation, which led to disputes among creditors regarding recovery values.

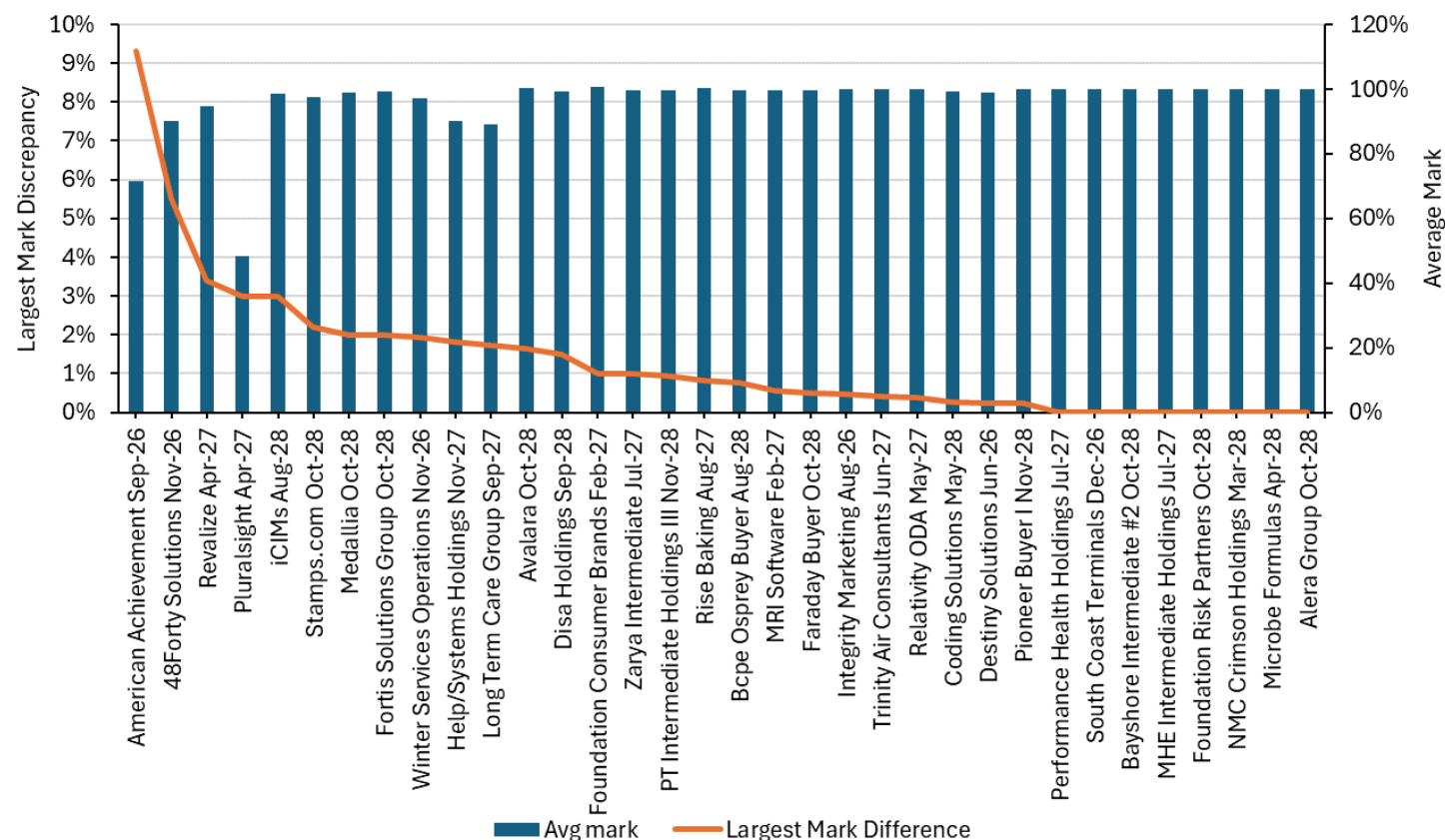
Pluralsight Restructuring

In March 2024, seven lenders of Pluralsight loan reported wildly divergent valuations for Pluralsight debt, with marks ranging from 83.5 to 97 cents on the dollar.

Blackstone Real Estate Income Trust

BREIT, a \$114 billion private real estate fund established in 2007, faced skepticism over its valuation, including allegations that its NAV is inflated by over 55%.

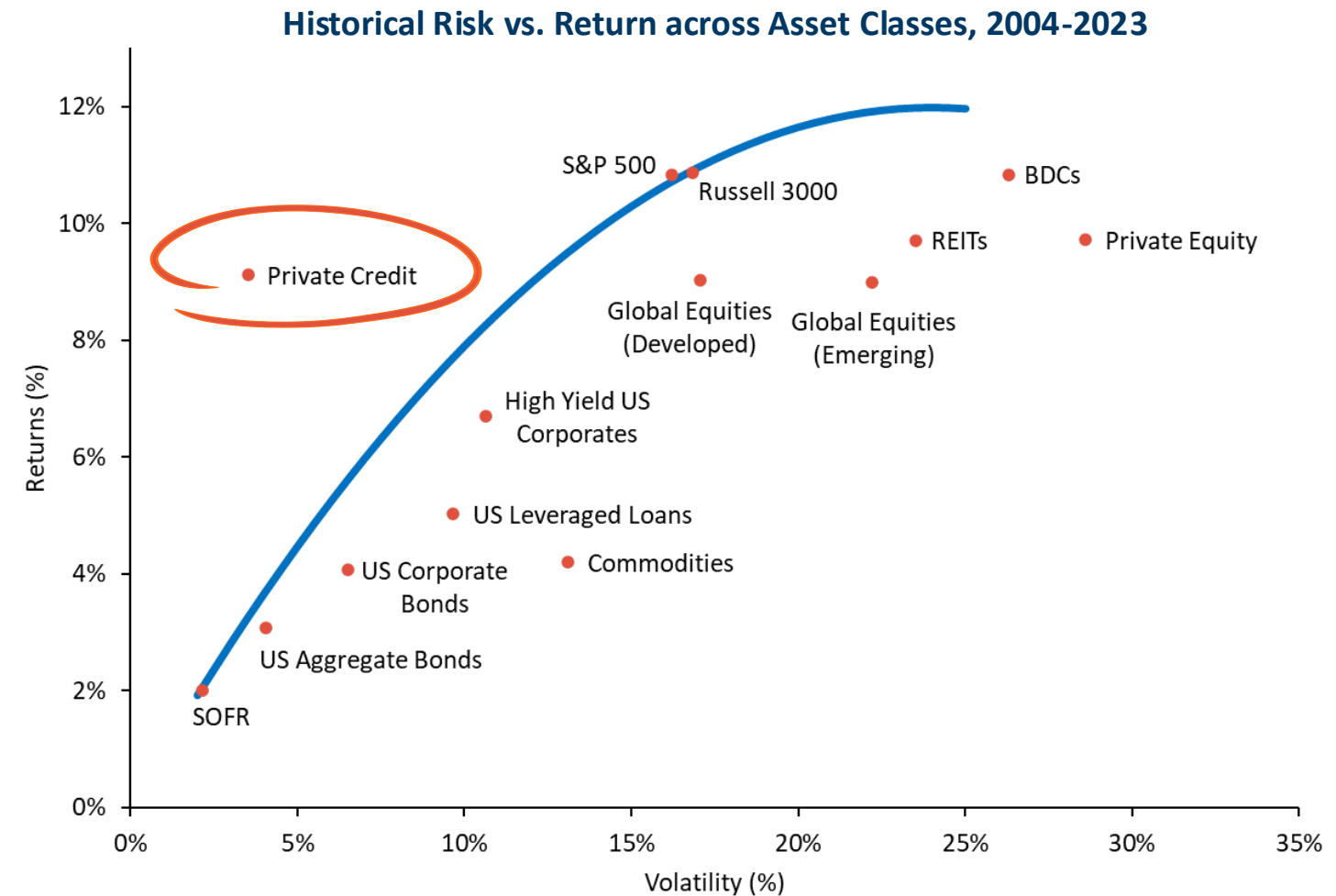
Mark Discrepancies for BDC Loan Investments



Challenges Faced by Private Credit – Hidden Volatility

Private credit performance metrics, such as IRR, do not fully capture the underlying risk.

- Private credit exhibited superior historical performance:
 - A similar risk to the U.S. aggregated bonds, but approximately three times as high return.
 - Comparable returns to equities, REITs, and similarly illiquid private equity, with only a fraction of the risk.
- From an investor’s perspective, the main concern is whether these superb performance metrics come at the cost of higher underlying risk.
- A lack of clarity surrounding the true volatility of these assets likely hinders investor confidence.



Private credit distinguishes itself with high returns and exceptionally low volatility. But questions remain whether the superb performance should come with higher underlying risk.

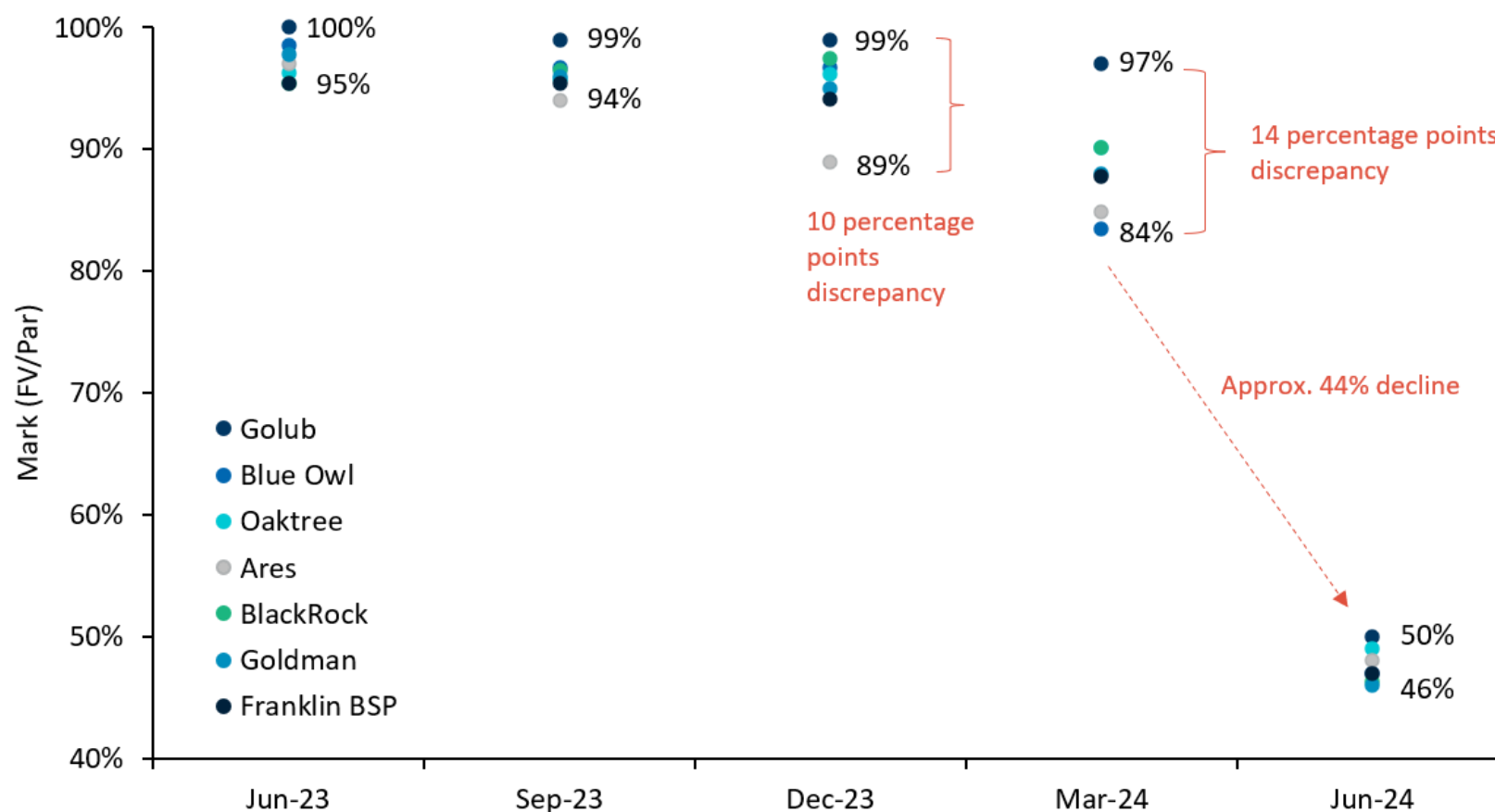
Challenges Faced by Private Credit – Mark to Model & Hidden Volatility

Infrequent pricing and potential asset price smoothing can further distort the perception of risk.

- The opacity of private credit, coupled with proprietary data held by asset managers, necessitates a strong reliance on the managers' expertise.
- The changes in BDCs' marks of the Pluralsight term loan illustrate the challenges faced by private credit:
 - The divergence in marks widened from 5 to 14 percentage points between September 2023 and March 2024.
 - By June 2024, as Pluralsight approached restructuring, the marks plummeted to 46-50 cents on the dollar.
 - The 44% drop in the average marks between March and June 2024 likely occurred well before the reporting date.

Investors, typically only privy to quarterly marks, may find it difficult to assess their investment risks timely and accurately.

BDC Marks of Pluralsight Term Loan, Q2 2023 – Q2 2024



Importance of Independent Verification

Private credit has evolved into a significant market segment. However, the market's growth and accessibility to capital is limited by investors' skepticism around accurate and timely valuation of private debt assets.

Independent verification ensures

Enhancing Transparency

Independent verification ensures that private credit valuations accurately reflect true market conditions, adding a layer of transparency.

Refining Valuation Policies

Complementing the independent valuation process, fund managers can have their valuation policies explicitly defined and articulated to stakeholders.

Providing Volatility Assessment

Regular and timely valuations provide more accurate assessment of volatility and a realistic understanding of the risks involved.

Fostering Investor Trust

Independent valuations enhance the reliability of private credit assets' returns and foster investor trust by demonstrated managing of potential conflicts of interest.

Promoting Market Growth

Increased transparency can attract more investors and promote the further growth of the private credit market.

As the market matures and faces increased scrutiny, the ability to provide transparent, reliable valuations may become a key differentiator for fund managers and a critical factor in attracting and retaining investor capital.



Notes and Sources

Notes and Sources

- 2023 and 2024 fair value marks from BDC Form 10-Qs and 10-Ks, available at SEC Edgar: <https://www.sec.gov/search-filings>.
- Data from Bloomberg L.P.:
 - S&P 500 Total Return Index
 - Russell 3000 Total Return Index
 - Bloomberg Commodity Index 3 Month Forward index
 - Morningstar LSTA US Leveraged Loan Total Return Index
 - MSCI World Total Return Index
 - MSCI Emerging Markets Total Return Index
 - Cliffwater Direct Lending Total Return Index
 - S&P Listed Private Equity Total Return Index
 - Bloomberg US Aggregate Bond Total Return Index
 - Bloomberg US Corporate Bond Total Return Index
 - Cliffwater BDC Total Return Index
 - Bloomberg US Corporate High Yield Total Return Index
 - Dow Jones US Select REIT Total Return Index
 - CME Term SOFR 3 Month