ARENA INVESTORS LP

AUGUST 2024

Our thoughts on the "Golden Age" of Private Credit

We have recently received a number of client questions on today being a "Golden Age"(1) of private credit and wanted to provide our thoughts.

In short, we think that:

- The distinction between leveraged lending and direct lending has become very blurred.
- When the CLO market evaporated in the roughly nine months from 4Q2022 through 2Q2023, there was a window when direct lending was, in fact, significantly more attractive than it had been during the run-up to the peak of the "Everything Bubble" that ended in late 2021.
- But that transitory opportunity has now passed, in conjunction with direct lending managers raising record amounts in new funds without yet having grappled with the credit problems that are burgeoning in pre-2022 vintages.
- Investors are frequently not provided with information sufficient to assess either their current or prospective direct lending investments.
- All that said, there are many attractive opportunities in private credit beyond direct lending (to be reviewed in more detail in a subsequent note, or at your request).

Terminology

First, we think it is important to quickly define a few terms.

Direct lending (often misconstrued as being synonymous with private credit) is the largest segment within non-bank finance and is traditionally defined as making loans directly to companies, typically middle-market (i.e., below $1 billion in revenue), without the use of intermediaries (e.g., investment banks) as arrangers or agents.

Leveraged lending, meanwhile, is the facilitation of a buyout/acquisition/recapitalization, typically to larger companies, and is funded by banks or insurance companies, most often through the broader syndicated loan market, through CLOs (which raise money to invest across pools of leveraged loans and the aggregation and redistribution of risk).

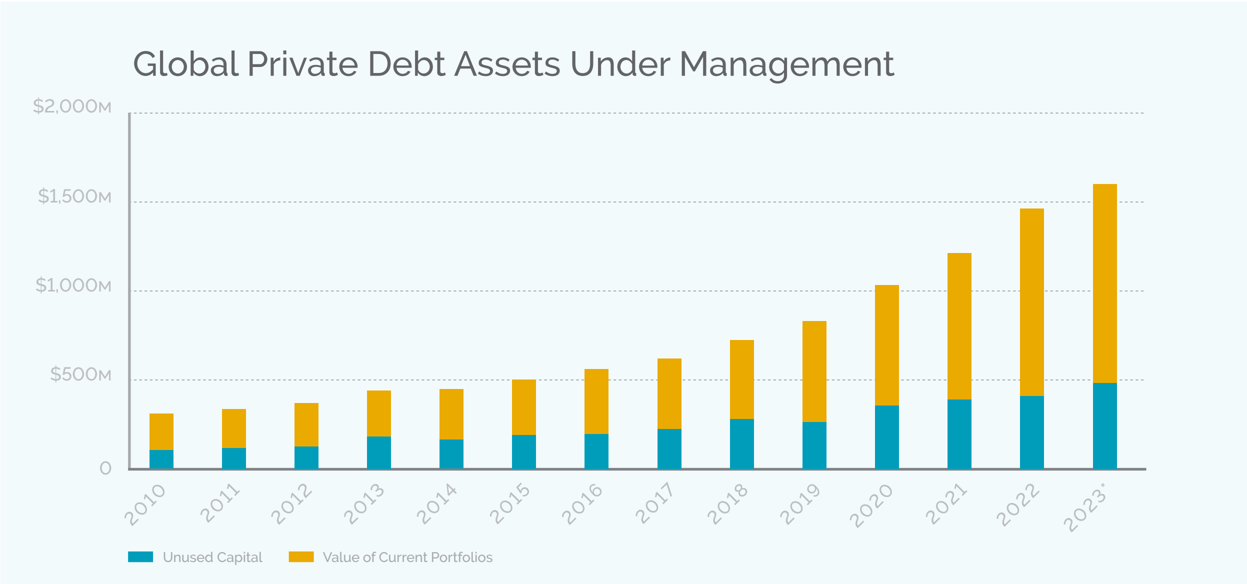
If you were to ask ChatGPT, "what is the difference between direct lending and leveraged lending?" it would erroneously synthesize that direct loans are senior-secured (containing strong, company-specific covenants) and made to stable companies with strong cash flows, good credit ratings, and with low leverage–whereas leveraged loans are extended to poorer-quality companies with a more substantial amount of debt, where covenants are only tested at inception or when there are material events (versus on an ongoing basis).

(1) This term is synonymously used to speak to the growth of assets in direct lending (and the corresponding benefit to GPs) as well as the attractiveness of the investments themselves (and the benefit to LPs). This piece speaks to the latter, while recognizing the actual metaphorical term would best apply to the former. Using the Wikipedia definition, the Golden Age was a time when "people [GPs] did not have to work to feed themselves for the earth [LPs] provided food in abundance." In this way, we would agree it is a "Golden Age," while noting the two perspectives are negatively correlated to each other (i.e., having capital flood a certain investment type makes it less attractive, all else equal).

Blurred lines

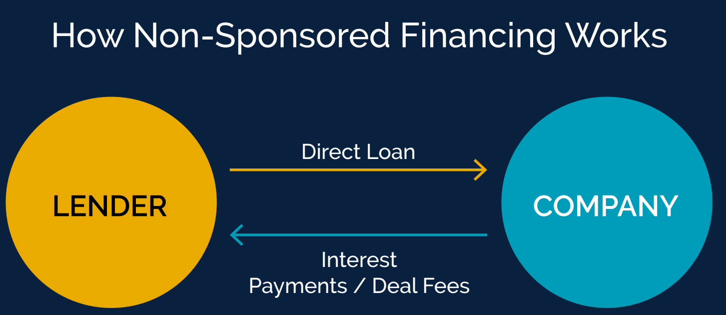
While leveraged loans (syndicated to CLOs, insurers, and bank loan funds) do tend to be larger on an absolute basis, the assets in direct lending have skyrocketed, causing the two segments to converge.

Direct lending (the largest part of private credit) has scaled significantly in assets. As shown below, global private credit assets have grown about five-fold since 2010 (and over 30-fold since 2000) and stand at over $1.5 trillion today, with direct lending representing nearly half.[(2)]



Source: Preqin Pro; *To March 2023
https://www.ubs.com/us/en/assetmanagement/insights/asset-class-perspectives/private-credit/articles/the-growth-story.html

Because private credit managers (particularly direct lenders) often use leverage, the actual assets at their disposal are even larger (e.g., at $1 trillion and 2:1 leverage, that number would be $3 trillion). Within direct lending, sponsor-backed lending represents nearly two-thirds of the assets,[(3)] contradicting the ChatGPT non-intermediated definition. Below is a schematic taken from a Brookfield presentation:

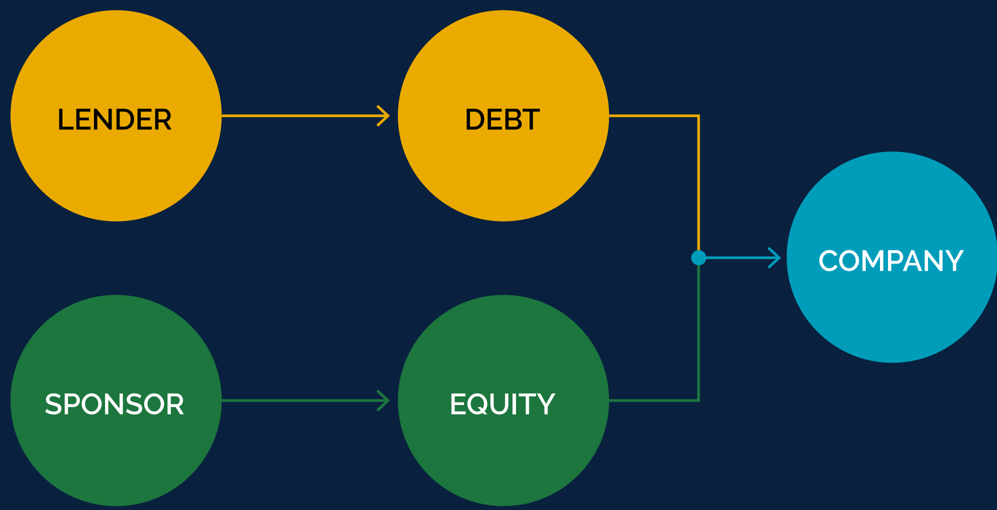


Lenders work directly with borrowers without a bank or intermediary [as arranger or agent]. Lenders assume a role akin to a sponsor, responsible for all aspects of due diligence and underwriting.

For example, an emerging life sciences company needs a loan to support new product development and approaches a lender that has industry expertise and a track record of working with similar firms. The company negotiates a bespoke loan on more favorable terms than might be available from a traditional bank with little understanding of this particular industry.

(2) Source: https://www.blackrock.com/institutions/en-us/insights/the-growth-of-direct-lending
(3) Source: https://www.spglobal.com/ratings/en/research/articles/231208-credit-trends-sponsor-diversity-can-mitigate-private-markets-risk-12940947

How Sponsored Financing Works



Sponsored financing allows companies to secure larger loans and more creative deal structures compared with traditional bank lending and typically results in higher leverage.

For example, a public company controlled by a PE firm borrows from a non-bank lender to fund a share buyback to go private. The PE firm provides the due diligence package and uses its relationships with lenders to negotiate a competitive loan.

https://www.brookfieldoaktree.com/sites/default/files/2023-05/Understanding-Private-Credit-Sponsored-Vs-Non-Sponsored-Financing.pdf

That said, how else could the universe of direct lending funds otherwise manage a 30x growth in assets? Non-sponsored lending is more complex and time intensive. While the investment returns and structures (for LPs) are structurally superior in non-sponsored loans, private credit investment firms (GPs) can far more efficiently scale based on the operational leverage they get from lending to multiple companies per sponsor.

Only by aligning themselves with sponsors (and in many cases also pursuing the refinancing of leveraged loans) have direct lenders been able to grow so significantly. The dependence on sponsors risks incentivizing more generous terms for loans (and, ultimately, amendments and restructurings) than would otherwise be the case if those firms' sources of new origination were not dependent on the same sponsors with whom they already have portfolio company lending relationships.

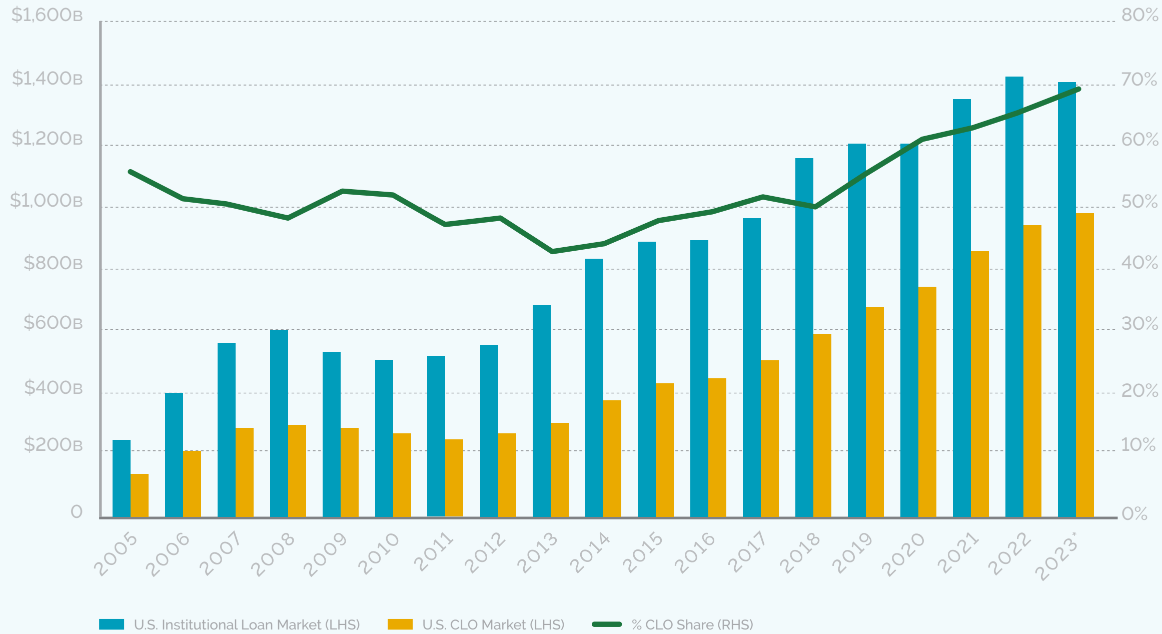
Leveraged lending has grown in parallel to the boom in direct lending assets, with leveraged lending having grown three-fold to about $1.5 trillion today.(4) This rapid growth has been in conjunction with an explosion in CLO issuance, with CLOs holding 70% of all leveraged loans. CLO managers have very little "skin in the game," particularly after even the *de minimis* 5% risk retention requirement was eliminated for non-middle market CLOs in 2018.(5)

As direct lenders have been writing ever larger checks, there has been an inevitable "race to the bottom." Direct lenders having to compete with leveraged lenders has led to compensation and terms that are generally more favorable for the borrowers (i.e., with their assets growing and having to compete with a larger funding source with little to no skin in the game, in addition to having the aforementioned structural conflicts between the use of sponsors as an origination source and the sponsors' obligation to fight for LP returns).

(4) Source: https://www.fidelity.com/learning-center/trading-investing/leveraged-loans-outlook
(5) Source: https://content.naic.org/sites/default/files/capital-markets-primer-collateralized-loan-obligations.pdf

CLOs Are the Largest Leveraged Loan Investor

CLOs purchased 69 percent of all new issue leveraged loans in 2022, and own 70 percent of the overall leveraged loan market.



Source: Guggenheim Investments, S&P LCD, Bank of America. Data as of 9.30.2023
https://www.guggenheiminvestments.com/perspectives/portfolio-strategy/understanding-collateralized-loan-obligations-clo

WSJ PRO BANKRUPTCY

Pro Take: Mega Loans Blur Lines for Private Credit and Banks

Direct lenders are issuing large loans to challenge banks' domains, and megabanks are making a land grab in the middle-market, an area usually dominated by direct lenders

By *Jodi Xu Klein*

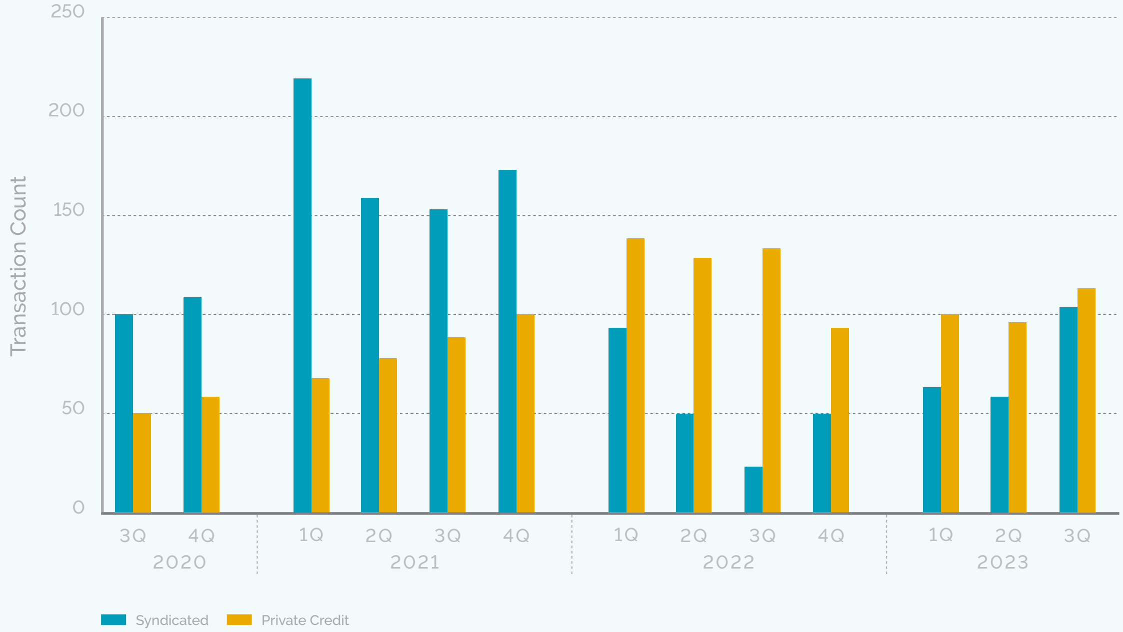
July 19, 2024

A major shake-up in corporate lending markets is obscuring the distinctions between traditional bank loans and private credit.

https://www.wsj.com/articles/pro-take-mega-loans-blur-lines-for-private-credit-and-banks-2c476e66

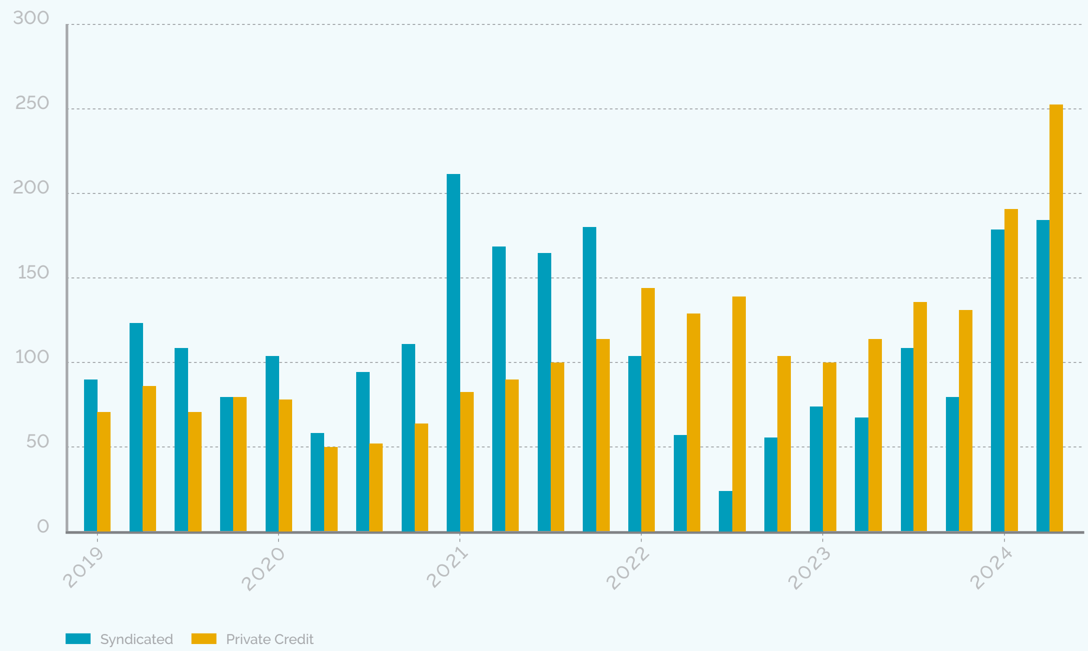
Private Credit Markets Have Been Replacing the Loan Market

LBOs Financed with Broadly Syndicated Loans vs. Private Credit



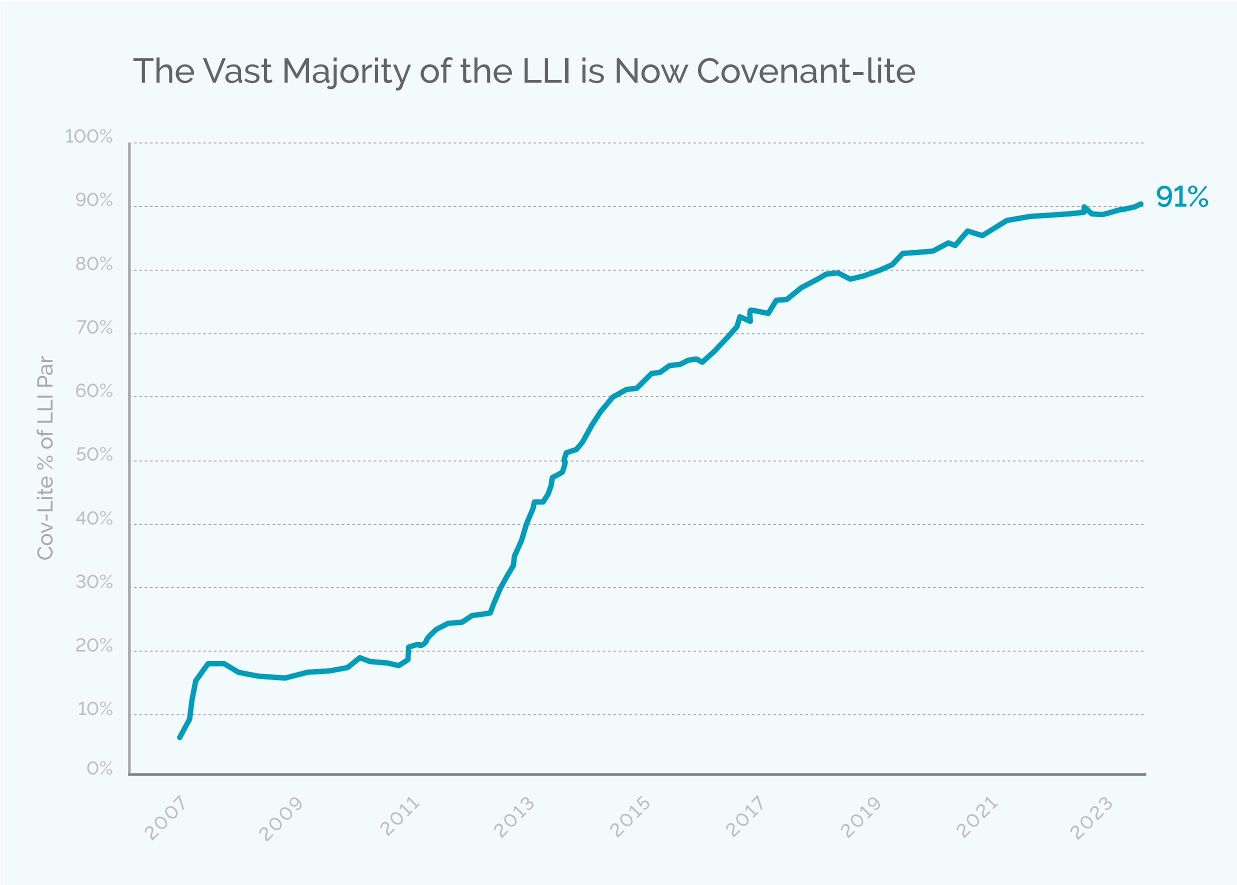
Source: Pitchbook: Data as of September 30, 2023; Private Credit Count is Based on Transactions Covered by LCD News
https://www.feg.com/insights/fourth-quarter-2023-private-capital-quarterly

Number of Non-leveraged Buyouts Financed with Syndicated Loans vs. Privated Credit



Source: Pitchbook | LCD; Note: Data Through June 18, 2024. Count Excludes Repricing and Extensions Amendments. Private Credit Count is Based on Transactions Covered by LCD News
https://www.wsj.com/articles/pro-take-mega-loans-blur-lines-for-private-credit-and-banks-2c476e66

Private equity firms, of course, benefit from having more access to capital, in that they can negotiate more favorable pricing and structures. The spread on newly issued term B loans to single B-minus-rated borrowers has now shrunk to its lowest level in six years,[7] and covenant-lite loans are now over 90% of the leveraged loan market.[8]



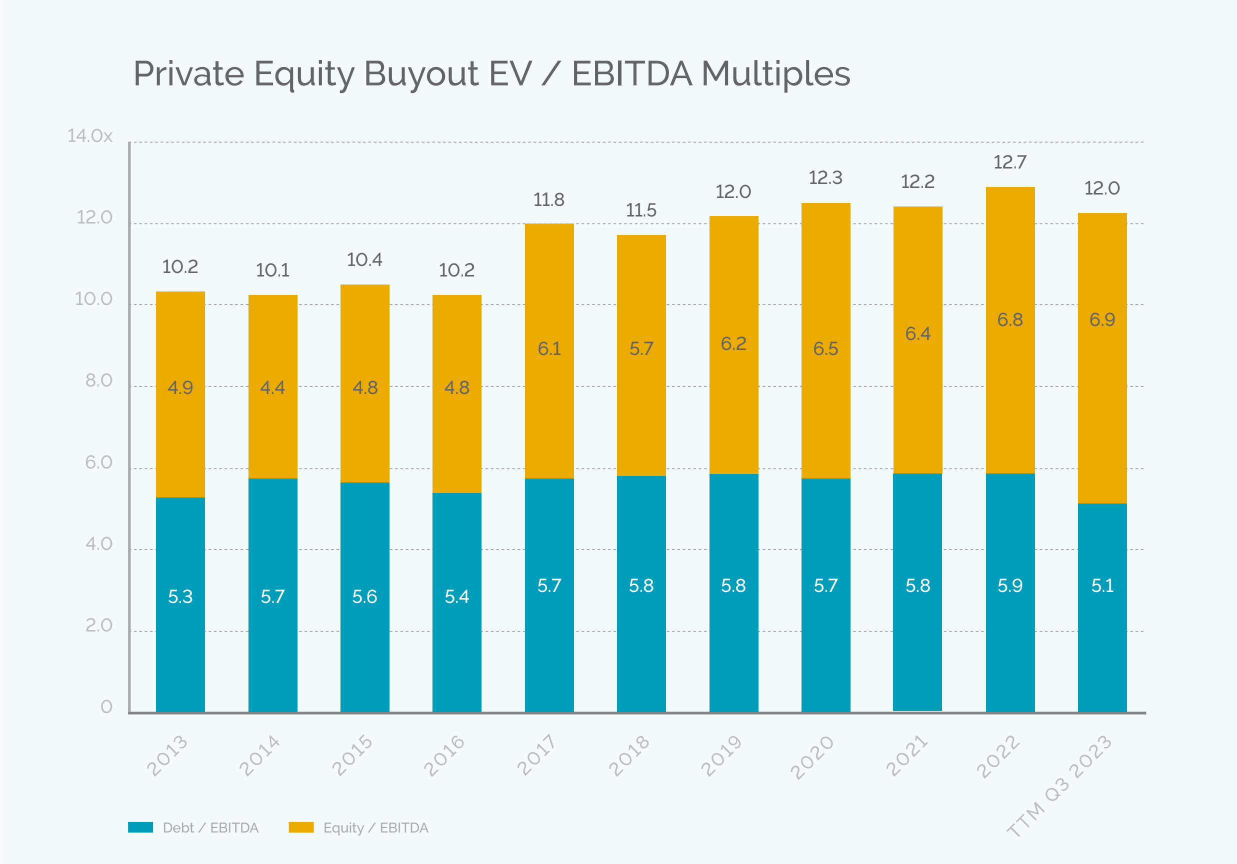
Source: Pitchbook. LCD, Barclays Research

They are also ever present in direct lending:

> "According to PitchBook | LCD, direct lenders traditionally limited the category of borrowers able to obtain debt on a cov-lite basis to those with at least $50 million in EBITDA, but as the market has become more competitive, private lenders have increasingly executed transactions on a cov-lite basis for some entities generating as little as $30 million in EBITDA ... In some cases, loans may contain covenants, but they are so generous that it would be unlikely they would be triggered unless the borrower incurred a rapid and significant decline in its financial performance ... More recently, direct lenders are [also accepting] terms including PIK interest and also [refinancing] broadly syndicated debt."

With access to more capital, the amount PE firms can borrow has been significant, at between 5x and 6x for over a decade (as shown below), whereas in the early 2000s, that number ranged from 3.3x to 4.4x[9] (also note that these more recent numbers are not readjusted for creative accounting such as EBITDA add-backs[10]).

(7) Source: https://www.wsj.com/articles/pro-take-mega-loans-blur-lines-for-private-credit-and-banks-2c476e66
(8) This has also led to the rise of "liquidity management exercises," where distressed borrowers raise new debt to the detriment of existing lenders by exploiting those entities having no covenants and hence no negotiating leverage.
(9) Source: https://developmentcorporate.com/2018/12/12/pe-multiple-expansion-2000-2018/
(10) In a recent Proskauer survey, 88% of investment manager respondents noted they allow for 15% or more EBITDA add-backs in aggregate: https://prfirmpwwwcdn0001.azureedge.net/azstgacctpwwwct0001/uploads/04afee7ee387b67d0bf57a66d4d49a2c.pdf



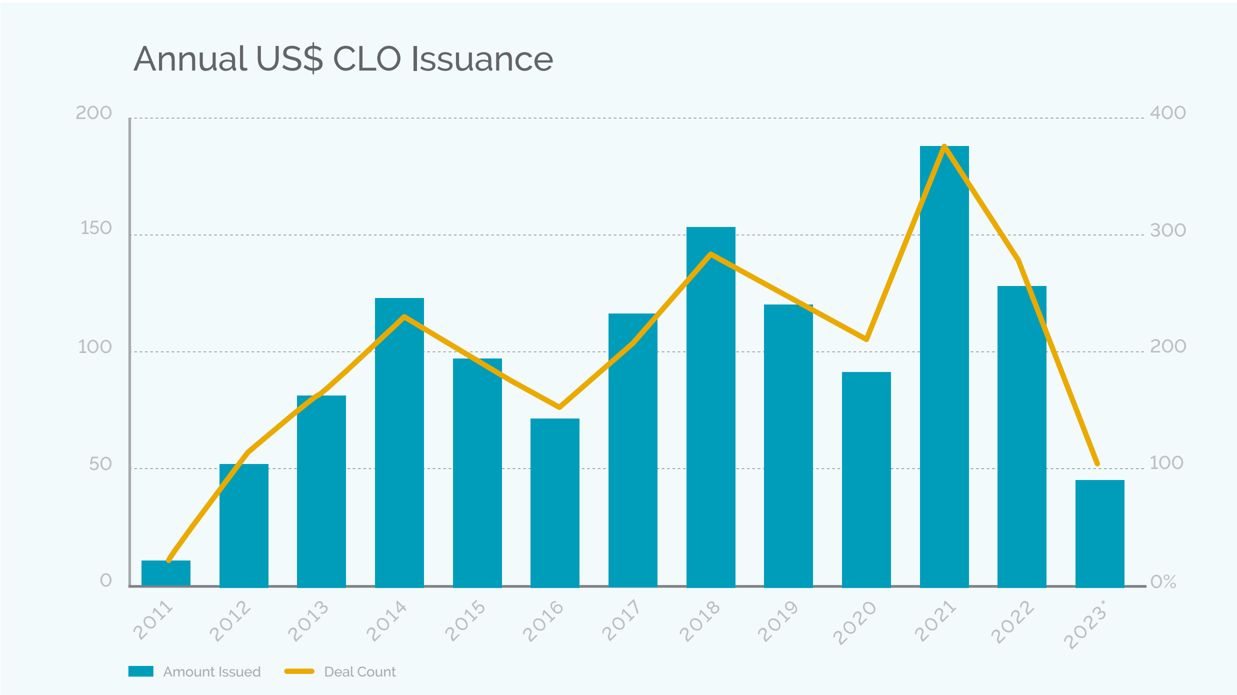
Source: Pitchbook. Q3 2023 U.S. PE Breakdown, EV / EBITDA Multiples, North America and Europe
https://www.commonfund.org/cf-private-equity/the-rising-cost-of-debt-impact-on-private-equity

In fact, from late 2021 to mid-2022, with so much funding available, there was even a period where yields between leveraged loans and direct lending converged, presumably reflecting a comparable risk exposure.

Source: J.P. Morgan; Data as of July 31, 2023. *YTM Included Original issue discount (OID). At Issuance Private Credit Deals Are Issued at a Discount to Par Value, Which Represents a Fee Paid from the Lender to the Issuer.
https://privatebank.jpmorgan.com/nam/en/insights/markets-and-investing/ideas-and-insights/can-private-credit-continue-to-perform

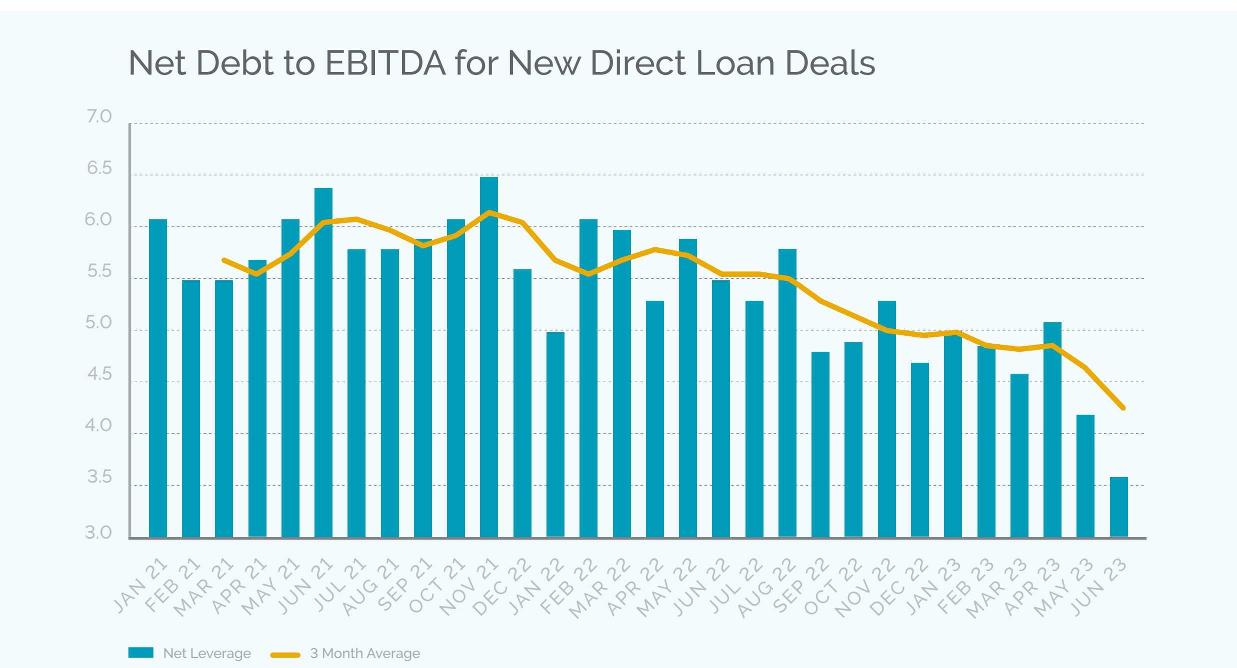
The "Golden Nine Months" for direct lending

The dynamics of the credit market underwent a notable shift in late 2022 through mid-2023, presenting a window of relatively attractive opportunity for direct lending. During that period, the CLO market experienced a cooldown caused by cracks in loan performance, the resultant decline in returns and availability of third-party CLO equity, and the large increase in AAA pricing due to rising interest rates.



https://flow.db.com/trust-and-agency-services/clos-weathering-the-storm#

With leveraged lenders temporarily out of the picture, direct lenders were able to extract better terms from borrowers. As one example, leverage multiples were significantly lower through this period:



Source: J.P. Morgan. Data as of June 2023. EBITDA = Earnings Before Interest, Taxes, Depreciation and Amortization
https://privatebank.jpmorgan.com/nam/en/insights/markets-and-investing/ideas-and-insights/can-private-credit-continue-to-perform

However, this advantageous window for lenders was only temporary. Direct lending funds continue to raise record amounts of new capital:


Goldman Sachs garners $20B for private credit strategy, closes flagship fund

By Nishant Sharma

Date published: May 29, 2024

Goldman Sachs Alternatives has raised a total of more than $20 billion for its private credit strategy, including the biggest pool of capital so far for the firm's senior direct lending efforts.

https://pitchbook.com/news/articles/goldman-sachs-garners-20b-for-private-credit-strategy-closes-flagship-fund

Alongside this, the CLO market rebounded forcefully (though mainly for refinancings versus new issuance), with the first half of 2024 having one of the highest refinancing volumes on record.[11] The market is again awash in liquidity.


Bloomberg

CLOs Have Too Much Money and Are Running Out of Things to Buy

By Carmen Arroyo and Eleanor Duncan

June 29, 2024

https://www.bloomberg.com/news/articles/2024-06-29/clos-have-too-much-money-and-are-running-out-of-things-to-buy-credit-weekly

In general, today's new investments are again resembling late 2021 dynamics.

Further myths

The attractiveness and "safety" of direct lending is also further obfuscated in several ways. Below we summarize a few comments we hear relatively often and provide our very broad-brush thoughts:

"It is okay for me to lend at 6x if the company is being purchased at 12x (and vice versa)."

Direct lending is universally regarded as a way to earn a premium return through the provision of liquidity that is otherwise unavailable to companies, but without regard to the price being paid. And because PE firms are willing to pay more, there is comfort that the level of "protection" is similar, even though the amount being advanced is that much higher.

Unfortunately, just because someone is willing to pay more does not mean it is intrinsically worth more. This false premise is only more troublesome in an environment where PE realizations (which peaked in 2021) are more infrequent.

(11) Source: https://www.tcw.com/Insights/2024/2024-07-25-Loan-Review

Any investment's return should be assessed by its future stream of discounted cashflows (more specifically the post-tax unlevered free cash flow).

If a PE sponsor pays 12x EBITDA for a company, we would note that:

- EBITDA does not equal post-tax free cash flow. 12x EBITDA (ignoring any creative adjustments) might generously be 18x post-tax free cash flow.
- An 18x multiple would imply a 5.6% annual yield (i.e., 1 divided by 18).
- Risk-free rates have gone from near-zero to 5%. So at an 18x multiple you are comparing a 5.6% yield that is uncertain against a 5% risk-free rate. Assuming a 400 basis point required premium to risk-free for a middle-market business, this would be worth about 11x post-tax free cash flow (about 7.4x EBITDA using the same ratio above), and at 6x of leverage, the LTV is really about 80% not 50%.

We note there is also another "myth" we are hearing more frequently: that LTVs have fallen in this environment and are around 50-60%. This myth conflates value with cost, as of course, LTV does not necessarily equal LTC.

"I am senior-secured, therefore, my investment is safe."

Given that the supply of senior debt has exploded, what is called "senior" has never been riskier.

Senior debt continues to go deeper (i.e., more junior) into the capital stack: 5x in 2010 versus over 7x in 2021, according to Pitchbook. And unitranche debt, combining first- and second-lien debt (or even what otherwise would have been unsecured high yield bonds), has become the instrument of choice, having seen 10x growth since 2016, according to Refinitiv data.

"Higher risk-free rates translate into higher compensation, making direct lending even more attractive."

All things being equal, paying a higher coupon means a higher percentage of cash flow is being used to service debt (with Lincoln International recently noting the percentage of private credit borrowers with fixed charge coverage ratios below 1x has risen from about 15% at the beginning of 2022 to 40% as of the end of 1Q2024). Only by paying less and/or borrowing less is that burden offset by the borrower. So while absolute compensation might be higher, so is one's risk.

"Default rates are low, and that is good, because defaults are bad."

Regulators and ratings agencies focus on coverage and defaults in their assessment of credit risk, whereas the far more effective measures of credit risk—leverage and severity—should be the key considerations.

To create the false perception of minimized risk by maximizing coverage and minimizing defaults, a lender can simply charge very little interest and have permissive covenants. To minimize leverage and severity, one would need to lend at responsible advance rates in robust structures, with frequent reporting and tight covenants, and be willing to proactively enforce lender rights.

Having lived by the coverage/default "sword," this optimization allowed for exaggerated leverage levels and drove purchase multiples higher. Now, with higher interest rates and significantly lower coverage levels, a "dying by the sword" will likely result from ratings downgrades due to reduced interest coverage that will require higher capital charges for securitized bonds financing the loans, which may spur selling by bondholders and finally reveal the losses in the underlying loans that were created in the market during the "Everything Bubble."

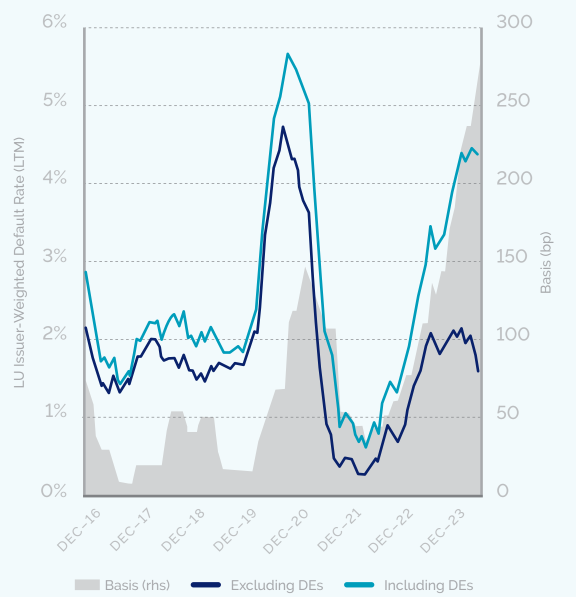
There are opportunities beyond direct lending

While direct lending generically represents another "index" exposure in a levitating market, there are many options for investors beyond those strategies that are fueling this GP "Golden Age."

In corporate cash flow–based lending, non-sponsored (or lightly sponsored) new-issue loans are attractive today, with smaller lenders and banks having retreated and without the attention of the larger-scale sponsor-backed direct lenders.

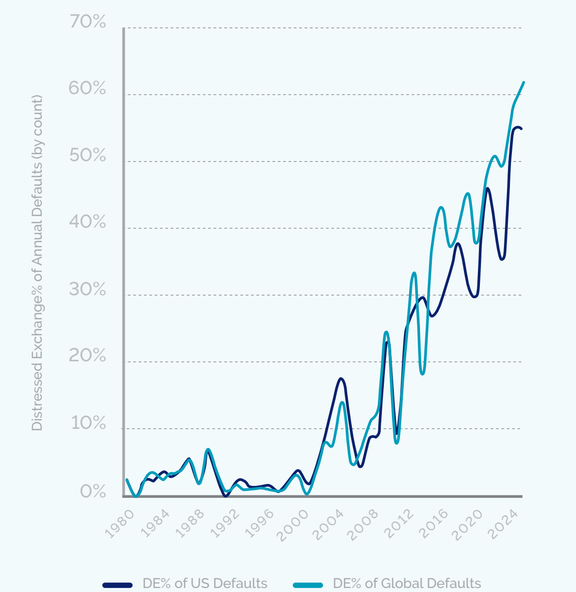
In addition, the overleveraging of enterprises during the bubble has fueled what is likely developing into a massive distressed investment opportunity, with lenders having advanced too much at over-optimistic valuations, low compensation levels, and with weak structures (e.g., a lack of covenants, EBITDA numbers that were cleverly presented with aggressive adjustments or add-backs). That said, we are only at the beginning. We expect to see many more forms of obfuscation that ultimately further impair long-term returns, such as today's current flavors of "liquidity management exercises" and "restructuring support agreements," alongside increasing "creditor-on-creditor violence," where lenders work to maximize their returns at the expense of other lenders, given the lack of covenants in many cases.

Classifying distressed exchanges as defaults has become increasingly important for default rate calculations ...



NB Across issuers of bonds and/or loans. © PitchBook LCD,Barclays Research

... since distressed exchanges have accounted for more than half of all US defaults since YE19.



NB Across issuers of bonds and/or loans. © Moody's, BarclaysResearch

Beyond US corporate cash flow lending, there are many attractive opportunities today across all forms of specialty finance globally (including corporate asset-based and real estate financing).

Many of the areas that are attractive today are not only higher returning and lower risk on an outright basis but are also diversifying and uncorrelated to direct lending. In other words, they represent a diversifying "satellite" as compared to the "core" market/beta of direct lending exposure.

In his novel, *The Possessed*, Dostoevsky said, "The Golden Age is the most implausible of all dreams." We take a similarly skeptical view of the prospect of a Golden Age of private credit that somehow benefits both LPs and GPs, though by opening the aperture, we believe investors can reap meaningful benefits.

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