Introduction to private credit

From the Field
2023

What is private credit?

- Private credit is an alternative asset class spanning several types of debt that is less liquid than traditional fixed income. This overview focuses on private lending, or direct lending, which is the largest of these markets. Private loans are typically directly originated between a corporate borrower and a small group of lenders. This differs from the traditional lending market where banks mostly arrange and place, or syndicate, loans with much larger lender groups.

- Private credit historically generated attractive risk-adjusted returns, driven by high current income, compared to traditional asset classes (see chart on page 2). Reallocating a traditional portfolio to include private credit can potentially increase returns while lowering volatility (see chart on page 4).

Typical features of private credit

Private credit offers economic and structural features that may be attractive to prospective investors.

Economic terms: Private loans typically offer an income stream from coupon payments, with potential yield enhancement from discounted issuance prices, fees, and call protection.

Floating rate coupons: Coupon payments are typically comprised of a base interest rate—plus a spread. Floating rate coupons adjust with interest rates, unlike fixed rate debt, helping mitigate interest rate and inflation risk.

Spread: The spread over the base rate compensates for illiquidity, complexity, and other credit risks. Private credit investors should expect this spread to offer a premium relative to traditional financings.

Discounted price: Loans are typically issued at a price less than par (USD 100), which is payable at maturity. This feature provides investors additional yield over the cash coupon when the investment is held until repaid by the borrower.

Structural features: Direct negotiations position private credit managers to balance borrower needs with terms and protections desired by investors, offering potential advantages to both parties.

Seniority and equity cushions: Senior loans sit at the top of a company's capital structure, which means they should be repaid before equity and junior debt, providing significant cushions against losses.

Lender-friendly structures: Private loans offer greater flexibility to negotiate lender-friendly documentation with protections designed to manage downside risk compared with traditional financings. These features may protect the loan's priority in repayment, underlying collateral, and other rights.

Buy and hold investment: Investing in private loans requires stable capital with a longer-term investment horizon. Many benefits of private lending are realized by holding the investment to maturity.

These economic and structural features have historically produced strong returns for investors over time. Investors can access private lending through open-end and closed-end fund structures, but should consult with their financial professional to learn more. Because of the nature of private credit there may be heightened risks for investors, such as liquidity risk and credit risk to the underlying borrower. In addition, as interest rates rise, bond prices generally fall. Investments in high-yield bonds involve greater risk of price volatility, illiquidity, and default than higher-rated debt securities.

What is the return profile of private credit?

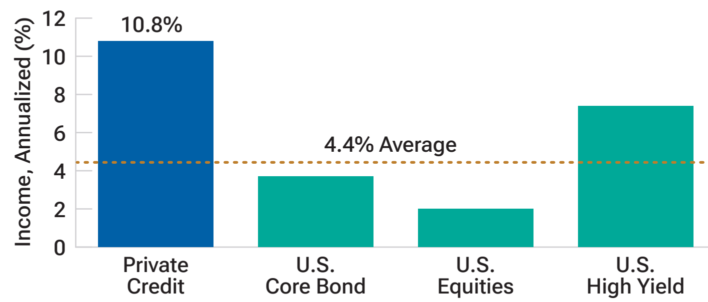
Private lending has historically provided several attractive return characteristics compared with traditional asset classes, including: (1) higher income, (2) higher risk-adjusted returns, and (3) lower volatility, as discussed below.

1. Higher income

Current income, as opposed to price appreciation, is the principal return driver of private credit. Private credit has generated higher income than traditional asset classes over time. Higher income has offered some protection against volatility and losses in times of market stress.

Asset Class Income Analysis[1]

September 2004–June 2023

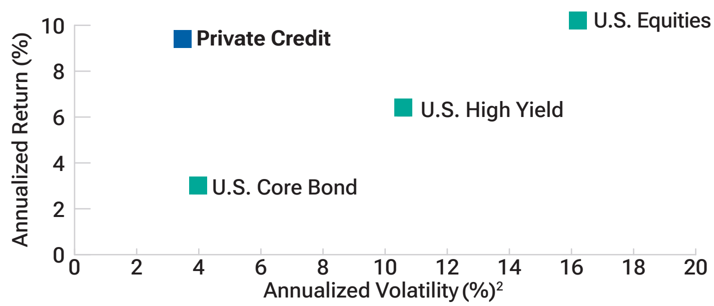


2. Higher risk-adjusted returns

Historically, private credit has generated higher returns with lower volatility relative to traditional asset classes.

Asset Class Risk-Adjusted Return[1]

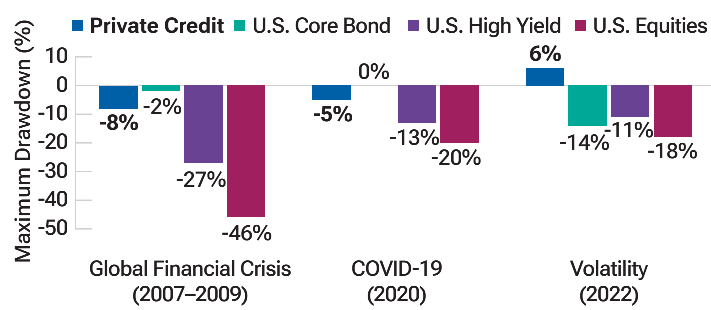
September 2004–June 2023



3. Lower volatility

Private loans are often designed with structural protections to manage downside risk through challenging market and economic environments. Private credit drawdowns in historical periods of market turbulence were muted compared with high yield bonds and equities.

Asset Class Scenario Drawdown[1]



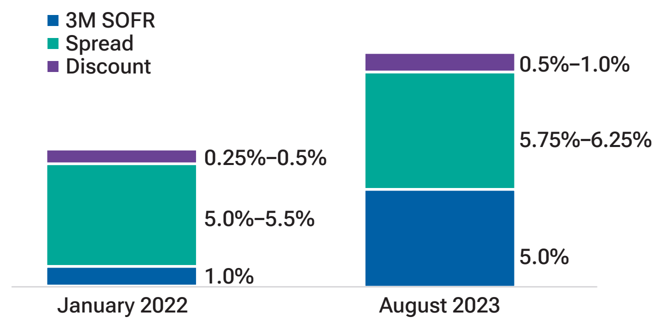
Past performance is not indicative of future results. Please refer to the Appendix and Endnotes.

What makes private credit attractive now?

We believe a more dynamic market environment, starting in 2022, has enhanced potential returns for investors considering the asset class. Higher interest rates, combined with increased spreads and price discounts, have significantly increased potential yields from private lending. Higher potential returns also reflect increased economic uncertainty, reinforcing the importance of credit underwriting and structuring discipline. The chart on the right shows the change in pricing for an illustrative private senior secured loan structured as the only debt in the capital structure.

Illustrative Pricing

Annualized components of return[3]



Why does the private credit opportunity exist?

We believe broad and durable trends within the corporate credit markets make private credit an attractive option for a long-term strategic allocation.

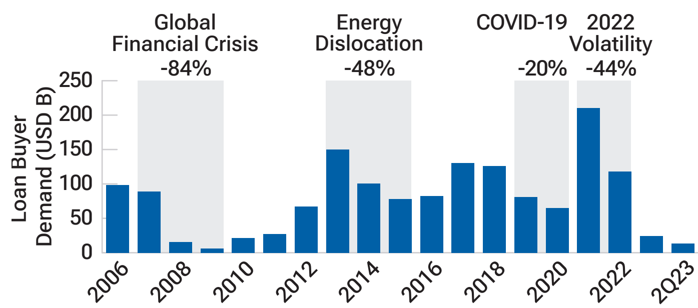
Supply/demand changes

Regulations implemented after the Global Financial Crisis pushed banks to retrench from traditional financing markets.

These changes made traditional financing markets less stable sources of capital, especially during times of market dislocation, such as those shaded on the right, when demand for traditional loans dried up.

Private lending has developed as a large and reliable alternative source of financing to address these changes.

Traditional Lending Sources Have Pulled Back, Particularly in Periods of Volatility[4]



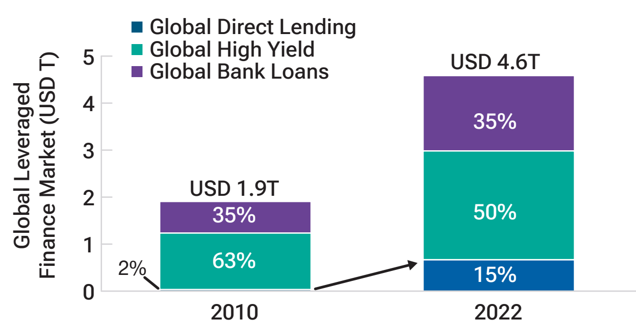
Increased market share

As traditional financing markets have become less reliable, private lending has grown significantly and has proven to be a resilient source of financing offering borrowers several advantages.

Potential borrower benefits of private financings include partnership with the lender, execution speed and efficiency, certainty of terms, flexibility of structuring, and confidentiality.

Borrowers are willing to finance at a premium in private markets to compensate lenders for their value-added solutions.

Private Credit Continues to Gain Market Share From Traditional Financing Sources[5]



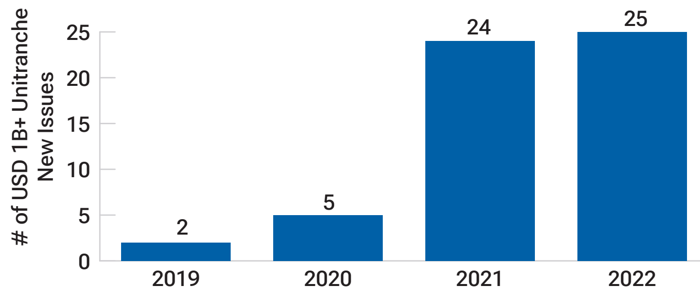
Why does the private credit opportunity exist? (continued)

Larger Borrowers: Larger borrowers increasingly seek private lending solutions as the private lending market continues to grow.

Historically, private lending was a source of capital predominantly to middle-market companies ($ <50M EBITDA). However, the opportunity to provide financing solutions to larger companies ($ >75M EBITDA) continues to grow dramatically. For example, private lenders are now executing $ 1B+ financings for companies that historically relied on traditional markets.[6]

We expect these trends to be persistent and long-lasting driving continued growth of the larger corporate private lending opportunity.

Number of Large Private Financings (USD 1B+) has Grown Significantly[6]



How does private credit fit into a portfolio?

Although we believe the return characteristics of private credit have the potential to make it an attractive standalone investment, investors should consider the impact that it may have when incorporated into a portfolio. As illustrated on the right, reallocating 10% of a traditional equity and fixed income portfolio to private credit would have reduced volatility and increased returns historically. A private credit allocation is also less correlated to traditional asset classes and offers a diversifying source of return driven by current income.

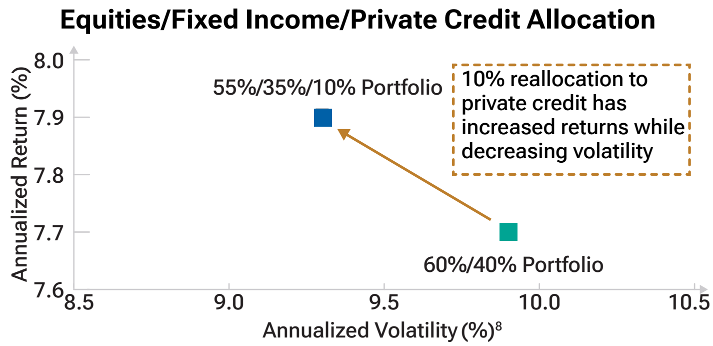
Funding an allocation to private credit will depend on an investor's current portfolio. Generally, funding sources may come from a mix of fixed income and equities as private credit offers fixed income-like lower volatility and equity-like higher returns. These attributes differentiate private credit from traditional asset classes.

While private credit typically exhibits lower volatility, investors should treat the allocation with a long-term horizon. We believe cash—or other liquid sleeves used to realize near-term goals—would not be appropriate due to the inherent illiquidity of the asset class.

Investors can access private lending through open-end and closed-end fund structures, but should consult with their financial professional to learn more.

Hypothetical Portfolio Risk/Reward Analysis[7]

September 2004–June 2023



Diversification cannot assure a profit or protect against loss in a declining market.

Appendix and Endnotes

[1] OHA analysis as of June 30, 2023. September 2004 reflects the inception date of the Cliffwater Direct Lending Index. Private Credit represented by the Cliffwater Direct Lending Index, U.S. Core Bond represented by the Bloomberg U.S. Aggregate Bond Index, U.S. High Yield represented by the Bloomberg U.S. Corporate High Yield Index, U.S. Equities represented by the S&P 500 Index. There is no representation being made that an individual investor will achieve returns similar to those shown. The volatility of the indices may be materially different from the individual performance attained by a specific investor. In addition, the portfolio holdings may differ significantly from the securities that comprise the indices. The indices have not been selected to represent an appropriate benchmark to compare an investor's performance, rather are disclosed to allow for comparison of the investor's performance in a certain asset class to that of certain well-known and widely recognized indices. An investor cannot invest directly in an index.

[2] Volatility is represented by standard deviation. Standard deviation measures the volatility of returns. Higher standard deviation represents higher volatility.

[3] Source: OHA analysis as of August 2023. "3M SOFR" represents the three-month Secured Overnight Financing Rate ("SOFR") as of the beginning of the month shown. Estimated spread and original issue discount has been prepared by OHA to reflect pricing of actual unitranche investments made as of the beginning of 2022 versus the current market.

[4] Source: JP Morgan, as of June 30, 2023. Demand is syndicated loan measurable demand calculated as the sum of retail inflows and collateralized loan obligation net issuance. Leveraged Loan Index is the Credit Suisse Leveraged Loan Index.

[5] Source: Preqin, Bank of America Global High Yield Index, S&P Global U.S. and Euro Leveraged Loan Indices as of December 31, 2022. Euro Leveraged Loan Index converted to USD as of December 31, 2022. Totals may not add due to rounding.

[6] Source: Direct Lending Deals as of March 31, 2023.

[7] OHA analysis as of June 30, 2023. September 2004 reflects the inception date of the Cliffwater Direct Lending Index. Private Credit represented by the Cliffwater Direct Lending Index, U.S. Core Bond represented by the Bloomberg U.S. Aggregate Bond Index, U.S. High Yield represented by the Bloomberg U.S. Corporate High Yield Index, U.S. Equities represented by the S&P 500 Index. An investor cannot invest directly in an index.

[8] Volatility is represented by standard deviation. Standard deviation measures the volatility of returns. Higher standard deviation represents higher volatility.

Appendix and Endnotes (continued)

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What is the Return Profile of Private Credit?

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