23RD ANNUAL ADVANCED RESTRUCTURING & PLAN OF REORGANIZATION CONFERENCE

AIRA Association of Insolvency & Restructuring Advisors

The Private Credit Market: Structure, Strategies and Valuation

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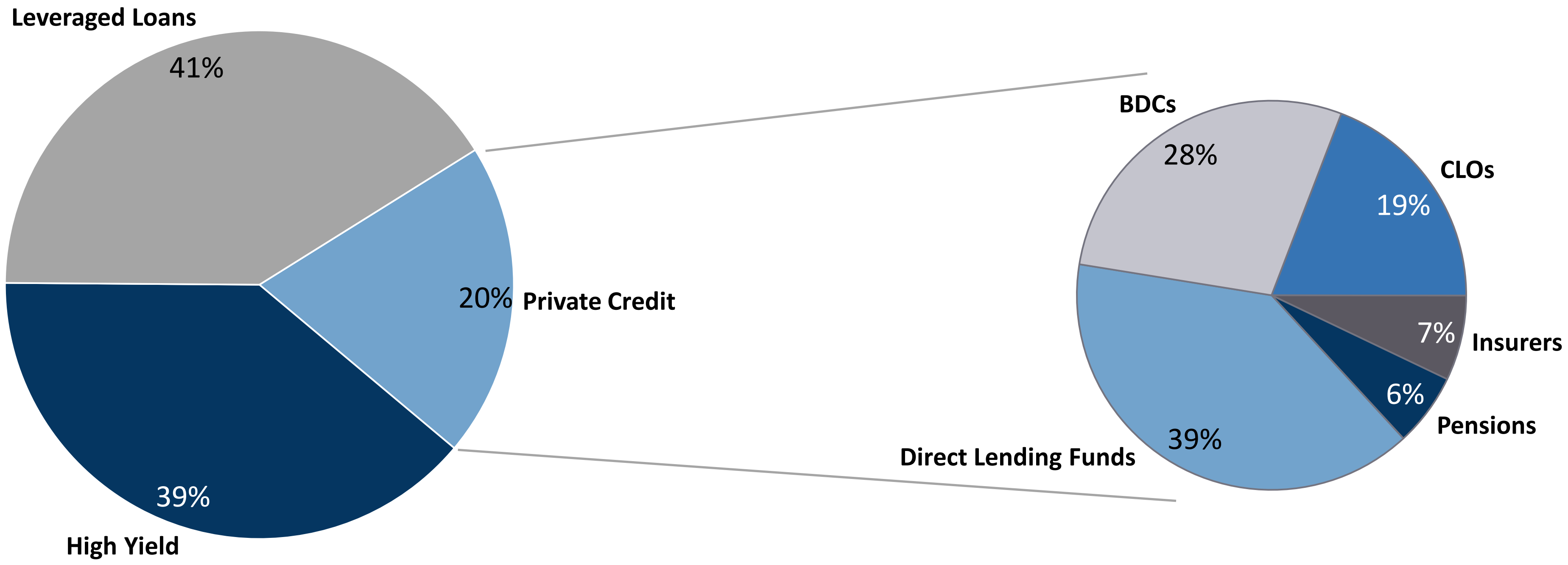
The Private Credit Market

- Overview of the Market
- Market Structure
- Fair value of Private Credit Instruments
- Restructuring and Workout Issues and Solutions

Overview of the Market

Private Credit: Fastest Growth in US Leveraged Credit Market

Direct lending market is the single largest contributor to private credit growth



Source: ICE, Pitchbook LCD, Morgan Stanley Research

Market Definition

- The market for private credit refers to lending, characteristically in the form of floating rate loans, that are negotiated directly between the borrower and lender, often an asset manager
- A segment of the $12 trillion alternative assets market, excluding real estate, the private credit market has grown to $1.6 trillion in assets under management according to March 2023 Preqin data, and is approaching the size of the widely followed U.S. high yield bond and leveraged loan markets
- Driving this growth has been the demand by borrowers for certainty in pricing and transaction execution, long-term, partner-like relationships, customized funding, and smaller transaction sizes
- Private credit extended in North America is equivalent to 25% of total outstanding commercial and industrial loans in the U.S. and this growth is expected to continue
- The private credit market is complex and not exempt from the effects of adverse changes in the economic environment. In valuing a private debt instrument, it is therefore important to measure how much of the opportunity and related risks are reflected in the price of the issue.

The Asset Class

- Corporate direct lending comprises the largest and perhaps most important segment of the private credit asset class
- As a core investment strategy, it most closely matches the characteristics of private debt in that it is cash paying, spans a broad variety of borrowers and industries, bears floating rates that mitigate interest rate risk, makes use of covenant provisions to insure security of principal, and provides the opportunity for liquidity through relatively short terms to maturity
- If underwritten appropriately, its risk is primarily related to the beta characteristics of private debt, as its returns are a byproduct of the broad drivers of the asset class, such as in an index
- Enhanced private debt strategies include litigation finance, reinsurance, royalties, infrastructure debt, real estate debt, asset-backed lending, rescue finance, venture debt, structured CLO debt, and mezzanine debt. Returns from enhanced strategies are expected to be higher than core strategies, by as much as 3-5% depending on the strategy and asset managers
- Accordingly, the risk is alpha driven and more dependent on the size of the manager’s allocations to certain credits, industries, and sub-strategies

Market Participants

- Direct loans are most often underwritten and held by asset managers who raise capital from private investors rather than bank deposits
- While regulated by the SEC, they are not subject to the same regulations as commercial banks
- The investor pool served by asset managers is mainly comprised of institutional investors, including insurers, pensions, endowment funds, and foundations. On the flip side, retail investors are served by publicly traded business development companies
- There are at least 250 asset managers that invest in direct middle market loans in the U.S., an increase from 180 in 2019. Many entered the market during or shortly after the global financial crisis of 2008-2009, recruiting staff from banks that filed for bankruptcy, such as Bear Stearns and Lehman Brothers, or non-banks which cut back on their participation, such as GE Capital, which through its subsidiary Antares was once the largest nonbank lender
- Much of this growth is attributable to private equity, with PE sponsors backing as much as 75% of direct loans currently. While as compared to asset managers, banks have a significant advantage by having a lower cost of funds in the form of deposits, this advantage is counterbalanced by regulations that require higher capital requirements, restrictions on the type of loans they may make, and the level of leverage they can offer to borrowers

Private Credit Differences vs. Traditional Lending

Select Benefits

- Private credit lenders are more willing to review, diligence, and underwrite ‘storied credit’ opportunities
- Borrower terms and acceptable collateral / security may be more flexible and tailored to each situation
- Most private credit organizations are structured with lean and flat organizations, which enables quicker underwriting and amendment decisions
- Higher spreads and the acceptance of higher risks enable a broader set of potential solutions and actions upon credit deterioration, including restructuring and ownership

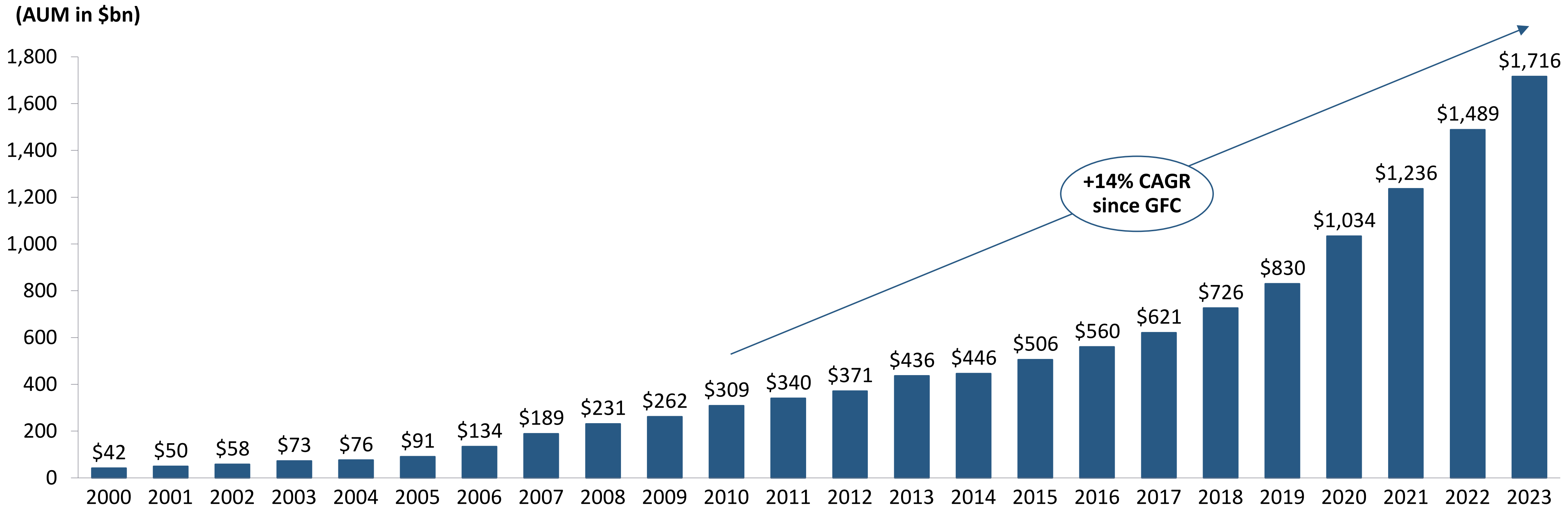
Select Limitations

- Private credit portfolios are concentrated in middle market-size companies; scale and size have challenges if overall portfolio performance deteriorates
- New capital investment / commitments expect that loan originations will continue at pace, which may pressure lean underwriting teams with sometimes limited credit cycle history and perspectives
- Secondary market for private credit loans is still developing (ETF and CLO volume continues to grow)
- Limited product bundling (i.e., treasury services, etc.) limit the visibility and relationship touchpoints with companies

Market Structure

Trend of Private Credit Market

Private credit market has enjoyed rapid AUM growth for over two decades



Notes: Private Credit market includes direct lending, BDCs, CLOs, and lending by insurers and pension funds
Source: The Federal Reserve, Preqin

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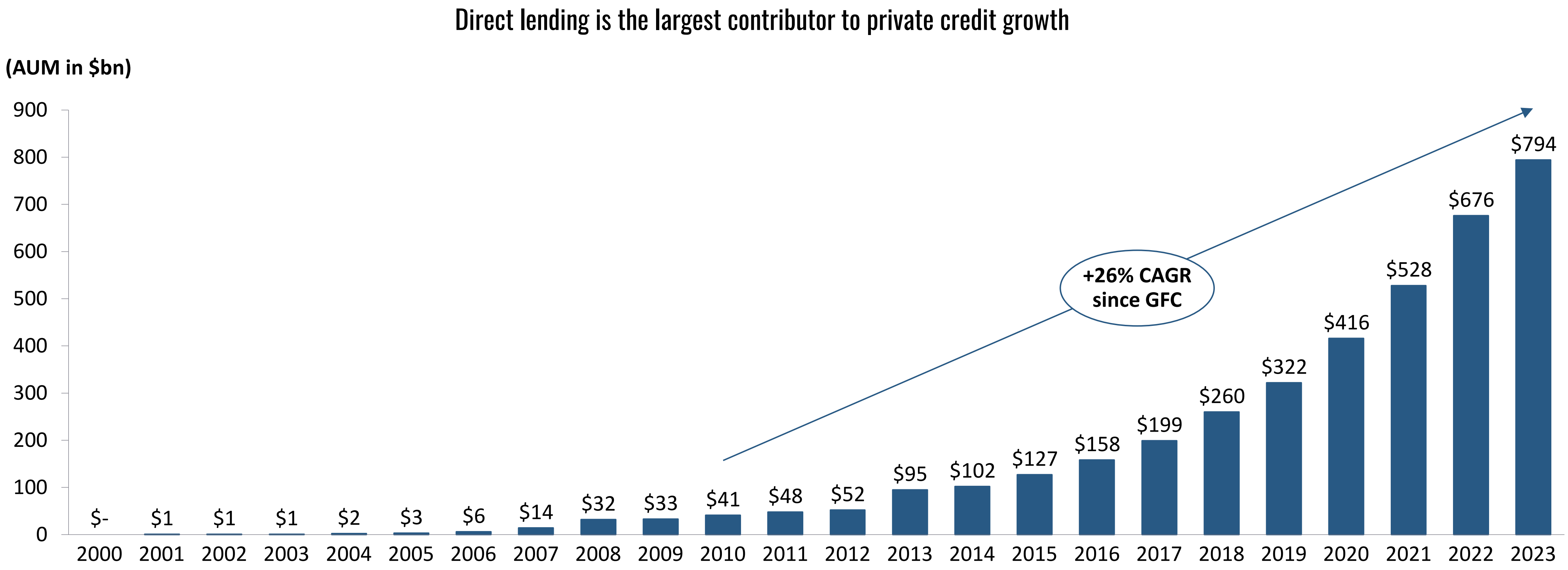
Trend of Direct Lending Market



Source: The Federal Reserve, Preqin

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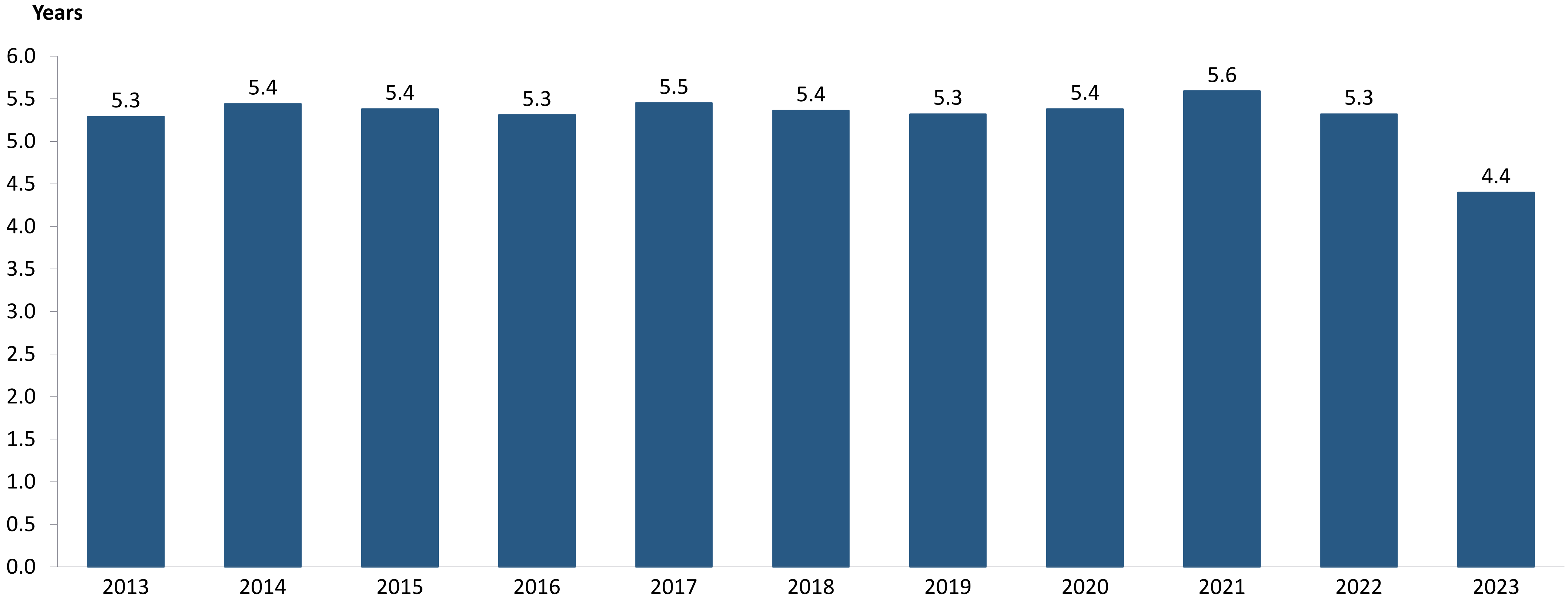
Average Maturity in Private Credit

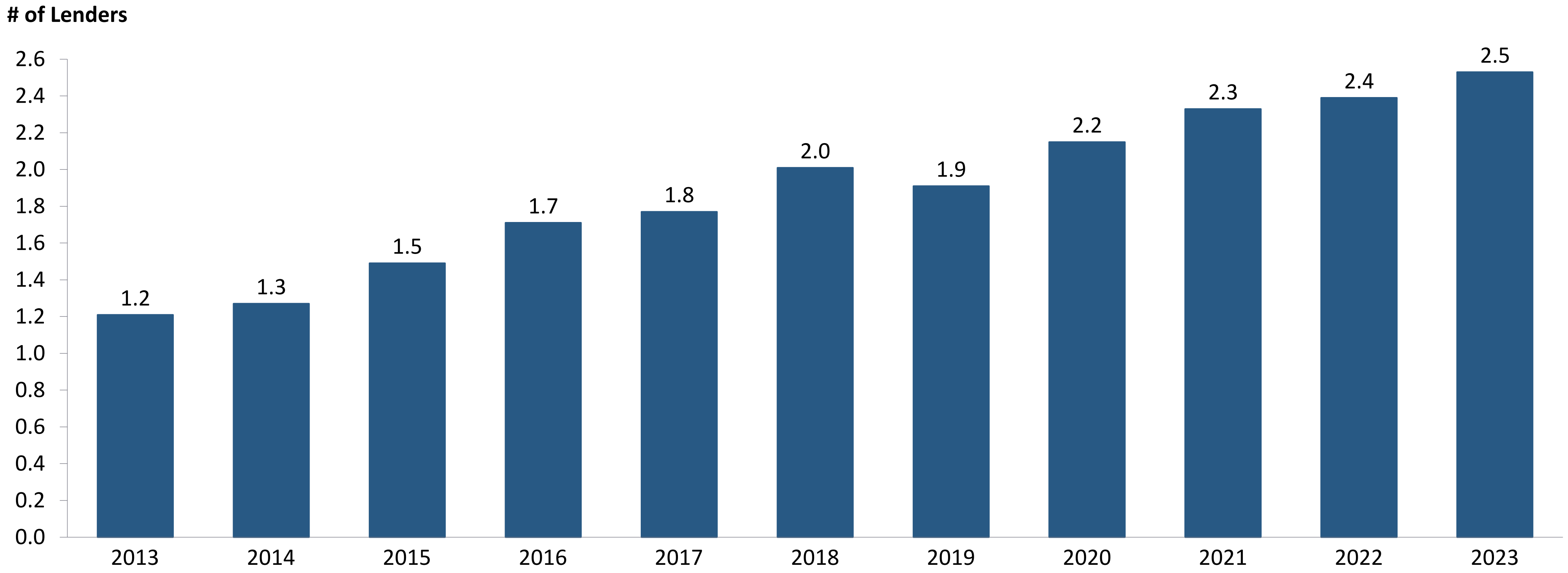
The average maturity in private credit has generally been around 5 years



Source: The Federal Reserve, Pitchbook

Average Number of Lenders in a Single Loan Facility

Private creditors are increasingly relying on "club deals" to share credit risk exposure to a single borrower



Source: The Federal Reserve, Pitchbook

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Trend of Largest US Direct Lending Funds

US Direct Lending (H1'24)

RANK	LENDER	COUNT	SHARE
1	Blackstone Credit	88	6.7%
2	Antares	80	6.1%
3	Churchill	78	5.9%
4	Twin Brook Capital Partners	77	5.9%
5	Morgan Stanley Private Credit	74	5.6%
6	Apogem	70	5.3%
7	Monroe Capital	65	4.9%
8	HPS	55	4.2%
9	Barings Private Debt	43	3.3%
10=	Audax Private Debt	37	2.8%
10=	Manulife Investment	37	2.8%
12=	Bain Capital Credit	34	2.6%
12=	Oak Hill Advisors	34	2.6%
14=	Ares	32	2.4%
14=	Crescent Direct Lending	32	2.4%

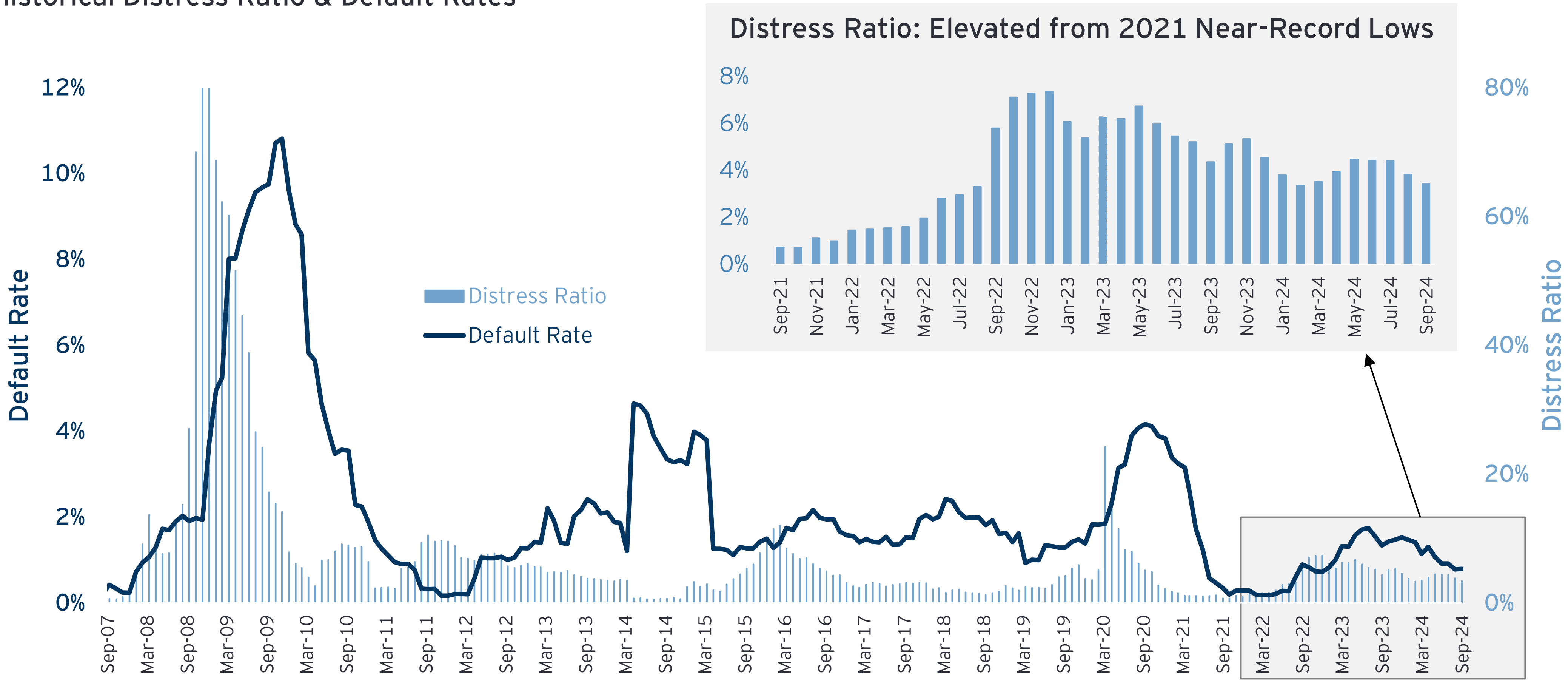
RANK	LENDER	COUNT	SHARE
14=	KKR Credit	32	2.4%
17	Blue Owl Capital	28	2.1%
18=	Deerpath Capital	27	2.1%
18=	MidCap Financial	27	2.1%
20	Golub	26	2.0%
21	NXT Capital	25	1.9%
22	Kayne Anderson	23	1.7%
23	WhiteHorse Capital	22	1.7%
24	Main Street	19	1.4%
25	Silver Point Capital	16	1.2%
26	Northleaf Capital	14	1.1%
27	Adams Street	12	0.9%
28	Goldman Sachs Private Credit	11	0.8%
29=	New Mountain Capital	9	0.7%
29=	Stone Point Credit	9	0.7%

RANK	LENDER	COUNT	SHARE
31=	PennantPark	8	0.6%
31=	Stellus Capital	8	0.6%
33=	Apollo	7	0.5%
33=	BlackRock	7	0.5%
33=	BMO Sponsor Finance	7	0.5%
33=	Carlyle Credit	7	0.5%
33=	Cliffwater	7	0.5%
33=	Sixth Street	7	0.5%
33=	StepStone Private Debt	7	0.5%
40=	AB Private Credit Investors	6	0.5%
40=	Comvest Credit	6	0.5%
42=	Brinley Partners	5	0.4%
42=	Guggenheim	5	0.4%
44=	Jeffereis Credit	4	0.3%
44=	Varagon Capital	4	0.3%

Source: Reorg

Distressed Credit Activity Still Relatively Benign

Historical Distress Ratio & Default Rates

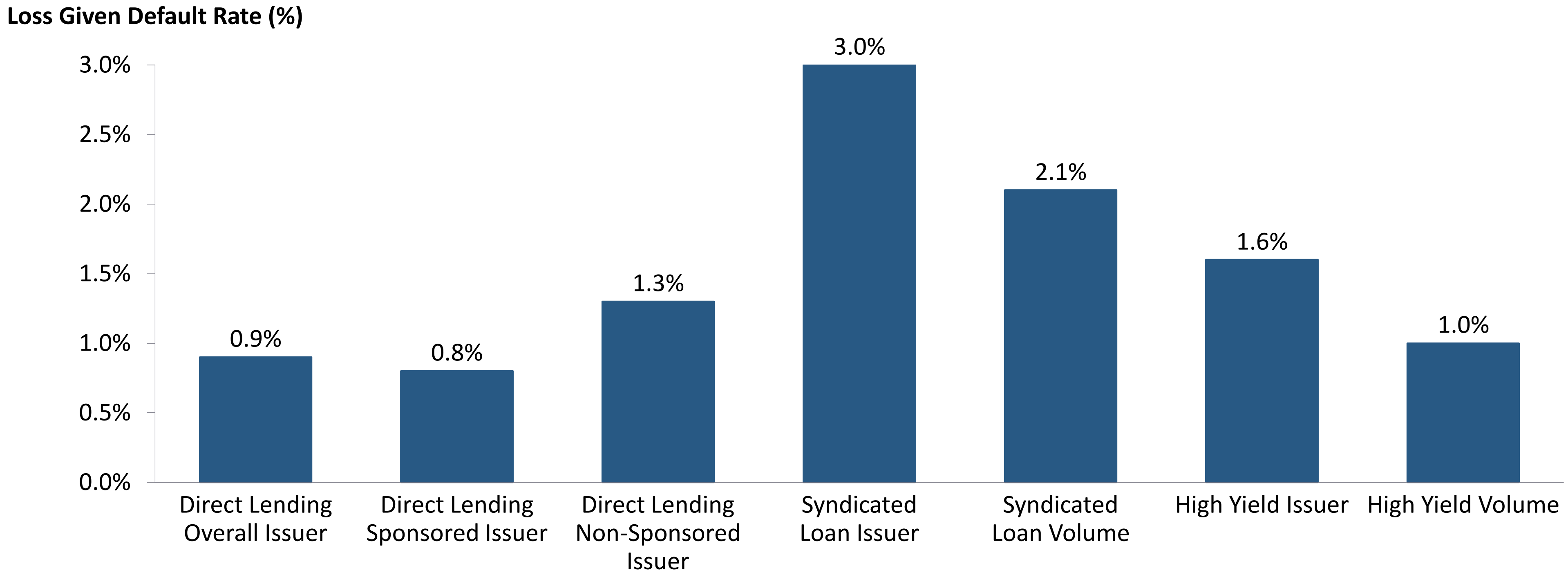


- Distress Ratio: represents loans priced below 80 and bonds trading above 1,000 bps yield spread
- Default Ratio: Trailing 12-month defaults weighted by principal amount

Source: Pitchbook LCD data

Direct Lending Default Rate

Direct Lending deals tend to have both incurrence and maintenance covenants, as well as stronger loan documentation

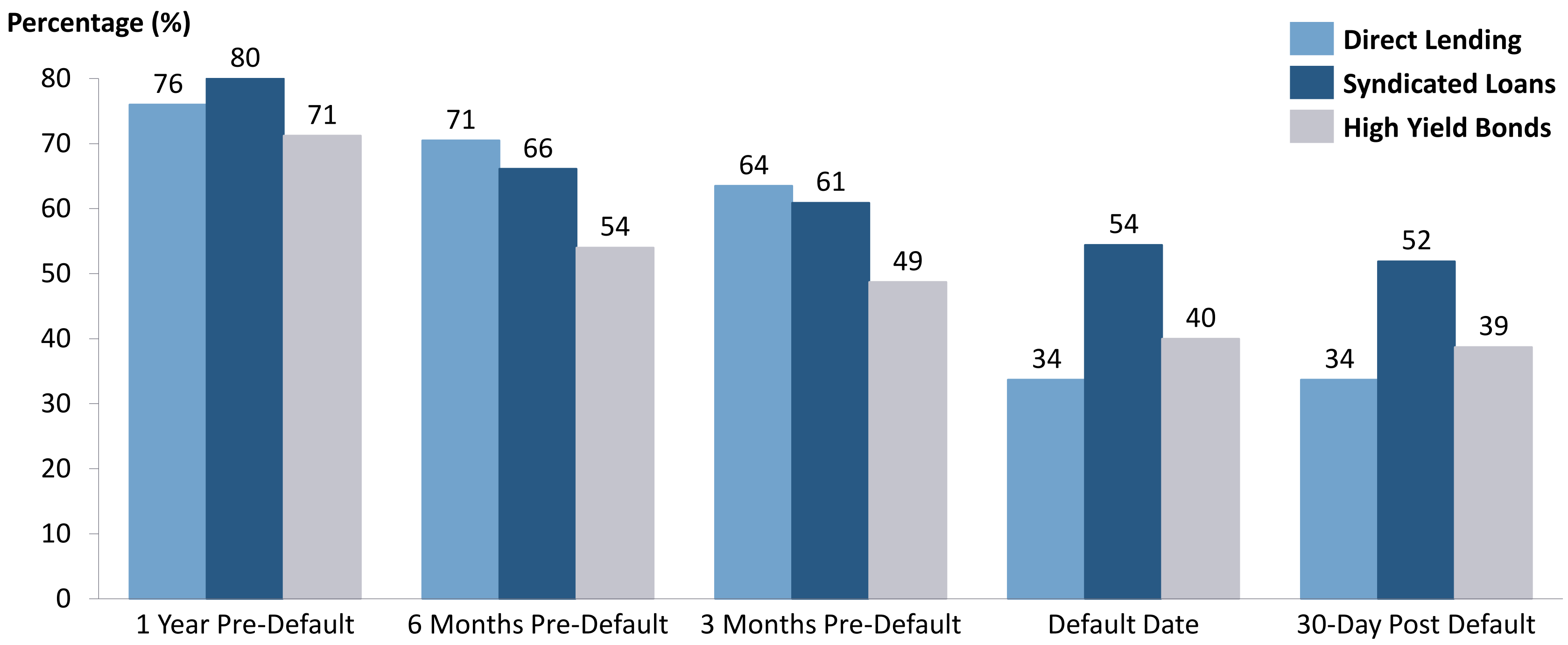


Source: KBRA DLD, Solve, BofA Research

Note: Low defaults may be attributed to (i) low rates for past 10 years and (ii) monitoring through tighter loan covenants and ability to renegotiate flexibly with small creditor group

Direct Lending Recovery Rate

>50% of direct lending borrowers are in sectors with low collateralizable / tangible assets - software, financial services, healthcare services



Source: KBRA DLD, Solve, BofA Research (Sept 2024)

Fair Value of Private Credit Instruments

Fair Value of Debt

- *The fair value* of debt reflects the price at which the debt instrument would transact between *market participants* transacting in the debt in an *orderly transaction* at the measurement date
- Factors implicit to the fair value of debt may include its contractual terms, including coupon rate of interest, time to maturity, amortization and prepayments, change of control provisions and conversion rights
- Other than its contractual terms, factors bearing on the fair value of debt may also include the financial performance of the company, information regarding the prospects of the issuer known to market participants, and the debt’s expected cash flows and market yield taking into account the riskiness of the debt and contemporaneous market conditions.
- In certain cases, proxies for the fair value of debt may be used to infer the value of equity. However, these proxies may not be indicative of the fair value of the subject debt, or the value of debt appropriately used to value equity
- These measures include par value, or notional value of the debt; face value, equal to par value plus accrued paid-in-kind interest; book value, equal to par value less any original issue discount, including debt issue discounts, which accrete to par value over the time to maturity; payoff amount, the value of the debt that would be owed if repaid on the valuation date; and trade prices, matrix prices, and indicative broker quotes.

Fair Value v. Interest

- The fair value of debt is not necessarily equal to its face value
- The fair value of a bond may be lower than face value if the rate of interest paid by the bond is below the market interest rate
- This can occur due to general market conditions and or credit issues specific to the company
- Conversely, for the same reasons, the fair value of the bond may be higher than face value where the bond provides for interest above the market rate

Fair Value of Private Debt

- The Financial Accounting Standards Board ("FASB") provides a framework for use in determining the fair value of private debt
- FASB Accounting Standards Codification ("ASC") 820 defines fair value as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date."
- For purposes of determining the process to be used to determine fair value, ASC 820 defines three categories of assets: Level 1, Level 2 and Level 3
- Level 1 is comprised of liquid assets that are valued using quoted prices in active markets.
  - Included in this category are listed equities, derivatives, mutual funds, and others having mark-to-market pricing systems such as that of a central exchange
- Level 2 assets in general trade in inactive markets and are valued using quotes from market participants rather than real-time transactions on central exchanges
  - Examples include credit default swaps and corporate debt, which may be priced using the average of indicative quotes from multiple broker dealers.
  - The majority of derivative instruments are also considered Level 2 despite that their value may be available from a central exchange

Fair Value of Private Debt (Continued)

- Level 3 assets, such as direct corporate loans, are not traded or trade infrequently

- Consequently, their value cannot be determined from market actions or inputs

- Level 3 assets are consequently valued using models that incorporate significant assumptions

Choice of Valuation Method

- The four main approaches to valuing private debt are the (i) income approach using yield analysis, (ii) net recovery approach, (iii) liquidation approach, and (iv) broker quotes
- The method selected depends on the availability of broker quotes and extent to which the enterprise value or collateralized assets of the borrower covers its debt positions
- If the subject debt is fully covered, but broker quotes and trading activity are not observable or considered reliable, then the income approach, using a yield analysis to benchmark the credit risk of the instrument, may be used
- If the subject debt is non-performing, irrecoverable or partially recoverable, either the recovery or liquidation approach would be used
- The three main questions that are typically asked in considering the appropriate methodology are (i) is it reasonable to assume 100% of interest and principal will be recovered, (ii) what cash flows are expected, and (iii) at what discount rate should the expected cash flows be discounted
- A rule of thumb is that if the implied Yield to Maturity ("YTM") is greater than 20%, the market does not expect a full recovery, in which case it would not be appropriate to use an income approach

Income Approach with Yield Analysis

- The three elements of the income approach using yield analysis method are the projected cash flows, discount rate and calculation of present value
- The first step is to create a schedule of cash flows the subject debt is expected to generate over the estimated remaining holding period based on the terms and conditions specified in the credit documentation, including coupon payments, payment frequency and day count convention
- The cash flows are then discounted to present value using a cost of debt commensurate with the risk of realizing the cash flows
- For non-traded, private debt, where the subject debt has a credit rating, the firm's cost of debt may be estimated based on the YTM of bonds of other companies having identical or similar maturities
- In cases where there is no credit rating, a synthetic credit rating may be developed by comparing a company's interest coverage and or leverage ratios with the range of ratios reported by a credit rating agency for each credit rating class
- It may also be feasible to determine a credit spread based on the credit rating and maturity of the subject debt and then add the spread to the benchmark risk-free rate to estimate the cost of the debt

Net Recovery Approach

- In cases where the Enterprise Value ("EV") Coverage analysis shows that the subject debt is not performing or expected to be fully recovered in accordance with its contractual terms though secured by a going concern, fair value may be estimated using the net recovery approach

- The net recovery approach is implemented applying a waterfall to the enterprise value of the company

- The value of the EV or collateral value may be measured using either the guideline company, guideline transaction or discounted cash flow method

- A recovery waterfall is then applied to the estimated EV or collateral value, with fair value determined based on the portion of EV or collateral coverage allocable to its position in the capital structure

Liquidation Approach

- When a firm has entered bankruptcy or is no longer considered to be a going concern, the fair value of its debt may be estimated using the liquidation approach
- In this approach, assets are appraised using assumptions reflecting distress, such as liquidation discounts and the fire-sale of assets in a forced sale
- As a result, fair value is reduced to reflect the time and costs of liquidation, in addition to the uncertainty of conducting a forced sale

Broker Quotes

- Broker quotes may be considered in the estimation of fair value, particularly if found to be reliable

- Factors that go into this determination include, but are not limited to, the
  - proximity of the quote to the valuation date,
  - volume of trades,
  - validity of the source of the data,
  - whether a known transaction occurred between related parties such as co-investors

- In cases where the broker quote is found to be unreliable, or the debt is not traded, consideration should be given to whether the loan is non-performing

Restructuring and Workout Issues and Solutions

Private Credit: Restructurings and Workouts

- No one-size fits all approach; every deal is unique, and different tools are required to solve different problems.
- Private credit providers have unique interests when loans become stressed that typically make them more conciliatory to a Borrower, including
  - Maintenance of sponsor relationships which are a source of lending opportunities and
  - Avoidance of fund-raising implications to a default.
- Smaller size of lending groups in private credit and “club” nature of deals can also make getting to consensus outside a chapter 11 filing easier.
- Downsides of a chapter 11 filing: cost, time, and legal / operational uncertainties

Private Credit: Restructurings and Workouts

- Majority of private credit restructurings remain "amends and extends"
  - Commonly use payment-in-kind (PIK) provisions and extension of maturities to address liquidity issues
- Other Types of Restructuring:
  - Debt-for-equity exchanges
  - Sales and change of control transactions
- Factors driving in-court v. out-of-court options:
  - consent required under loan docs
  - nature of problem – balance sheet v. operations
  - existence of legacy or litigation liabilities
  - benefits of getting a "free and clear" order
- OOC transactions subject to successor liability and fraudulent transfer risk, as well as anti-assignment provisions in contracts

Private Credit: Other Restructuring Tools

- Requirement that Borrower appoint CRO and/or Independent Director(s)
  i. Typically given responsibility for sale process and control of decision to file for bankruptcy
  ii. Provide greater certainty for lenders on Borrower financials
  iii. Can often drive restructuring strategy better than management
- "Golden Shares" - an equity interest in a company that affords the owner a number of consent rights. A key right is the right to block a company from filing for bankruptcy.
- Proxy Rights - give lenders the right to replace a borrower's board of directors with a new board made up of independent directors upon a default.

Summary

- Initially used to finance small transactions or firms having negligible or negative EBITDA, the market for private debt has grown significantly over the past decade
- Driven by borrower preferences for customized financing terms, investor diversification strategies, public market deal sizes exceeding the capacity for many middle market firms, and the contraction in bank credit availability, this growth is expected to continue
- The lack of transparency and liquidity inherent to the market remain key risks, however, with borrowers tending to be smaller, privately held, more highly leveraged and unrated
- Determining the fair value of a private debt instrument requires that these risks be calibrated and accounted for in evaluating the returns and pricing of the issue
- In the case of a default, when all else fails, tools available to drive a resolution include the appointment of an Independent director, use of proxy rights and the issue of a Golden Share