CHURCHILL
from nuveen

June 2024

Not all private credit is created equal: what to consider in an uncertain environment

Randy Schwimmer
Vice Chairman, Investor Solutions, Churchill Asset Management

Private credit continues to take market share in debt capital markets, though questions over its durability persist. In the current market environment, media and some research outlets are raising concerns about the risks a period of sustained high-interest rates may pose. Are private credit valuations supportable, or will they crash and contaminate the financial system leading to another financial crisis?

While we acknowledge the risks in this environment, we believe not all private credit is created equal. There is a stark contrast in the returns experience of private credit managers (figure 1) and, in the face of economic uncertainty, a disciplined approach to selecting borrowers is necessary to provide value to investors.

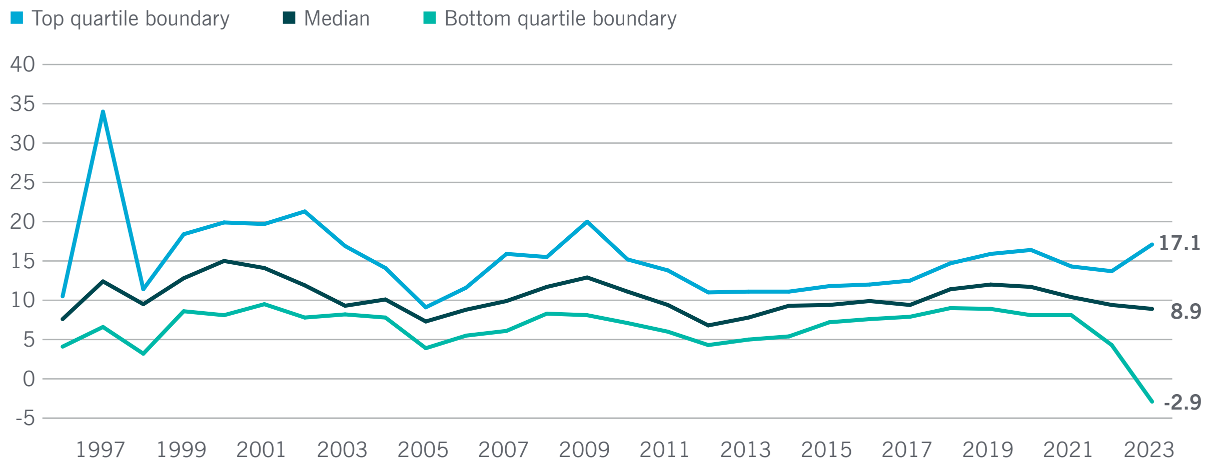
Intentionally investing in the core-traditional middle market can provide better relative value and strong risk-adjusted returns versus other areas in our view. This market segment typically provides conservatively structured financings that are appropriately sized and modestly levered, have higher sponsor equity contributions, tighter lender protections (covenants) and better pricing (credit spreads). Focusing on private equity sponsor-backed deals may also provide a sourcing advantage through strong relationships and solution-oriented approaches.

OPINION PIECE. PLEASE SEE IMPORTANT DISCLOSURES IN THE ENDNOTES.

NOT FDIC INSURED | NO BANK GUARANTEE | MAY LOSE VALUE

Figure 1: A stark contrast in private credit returns experience

Net IRR (%)



Past performance does not guarantee future results.
Data source: Preqin, - North America region focus, As of 31 Dec 2023

In our view, investors should seek to identify private credit managers that can provide transparent, disciplined investment processes, backed by expertise in specific market segments to deliver opportunities and returns from the start of the dealmaking process, right through the lifespan of a loan.

ORIGINATION: MATCHING OPPORTUNITIES TO AGREED-UPON RISK PARAMETERS

Origination teams tasked with sourcing new credit opportunities need to synchronize deals with the firm's agreed-upon risk parameters. We believe origination has three key components: manager expertise in market segments, how managers are able to build relationships and collaborate with private equity firms and how a manager approaches deal terms. These approaches will provide investors with early indicators as to how managers can identify and seek to influence opportunities to align with investor needs.

When private credit managers exclusively focus on private equity-backed businesses, the ability to foster private equity relationships is paramount. Being able to draw on a pool of potential partners which align with market and sector expertise will usually mean managers have a large pipeline of attractive deals in place, being made available through the strong, lasting relationships built with private equity partners.

The number of strong relationships a private credit manager has directly leads to a wider funnel of opportunities, and ultimately, higher selectivity that allows the firm to pick and choose the very best deals to benefit investors.

Managers with broad experience, especially dating before the 2008 financial crisis, gained a wealth of portfolio insights that help them navigate uncertain rate and economic environments. This includes employing sophisticated portfolio analytics and systems to produce key performance indicators (KPIs) for select industries and borrowers.

Best practice platforms make informed real-time decisions based on trends and performance of their portfolio companies. Managers who can offer investors expertise in specific market segments should have the resources needed to identify quality opportunities for investors.

Direct lenders who focus on the traditional middle market, like Churchill, understand the profile of borrowers therein. While terms vary depending on manager appetite and risk tolerance, there are consistencies across lenders. Pricing, leverage and

covenant packages offered significantly outside those parameters are recognized as either market misreads or signs of desperation.

A manager who can interpret these markers and compare them against the average movements of borrowers in the middle market, are better placed to put forward quality opportunities for investors, using their experience to spot the difference between attractive terms and warning signs.

Opportunities presented to investors will differ in quality, size and risk. However, managers that lead or co-lead on deals, rather than delegating or taking a passive approach to the early stages of a deal, can work to influence terms to best suit investor appetite.

UNDERWRITING: ADDING VALUE THROUGH LEADERSHIP

Investing in private credit brings inherent risk. Investors expose themselves to borrowers who, for many reasons, may be unable to fulfil loan obligations. Minimizing defaults is a byproduct of scrutinizing borrowers, ensuring their market share, services and business model set them up for longevity.

Borrower strength is assessed is multiple ways. Managers should consider whether a potential borrower's business models, for example, are easily replicated. If so, a borrower's market share could quickly shrink if and when competitors move in. Understanding how difficult it is for competitors to gain ground on the borrower's business model, and how reliant clients are on a potential borrower's business, will give managers a better idea of where a borrower's business will fare in different macro environments.

Other factors that will help evaluate a potential borrower is its reliance on revenue streams and customer bases. Business models which demonstrate diversification in both will be seen as more favorable compared to businesses that are reliant on a single service or consumer type.

However, this broad scrutinization of a business will only get managers so far. To present investors with high-quality and diverse opportunities, it is critical that managers are able to identify how one sector operates differently to another.

To do this, understanding how KPIs differ between sectors is crucial. Software-as-a-service companies, for example, track monthly customer retention metrics. Manufacturers monitor plant capacity utilization. Electrical grid component providers determine monthly backlog trends. Different sectors measure success in different ways, meaning managers must be able to understand those nuances to effectively assess a potential borrower.

There is no one-size-fits-all approach to private credit. Borrowers will vary widely in their business models, revenue, competition, sector and performance indicators. Having a manager that is able to scrutinize a potential borrower through various lenses, taking into account the unique characteristics of success in one sector versus another, will provide investors with more diverse and well-examined opportunities.

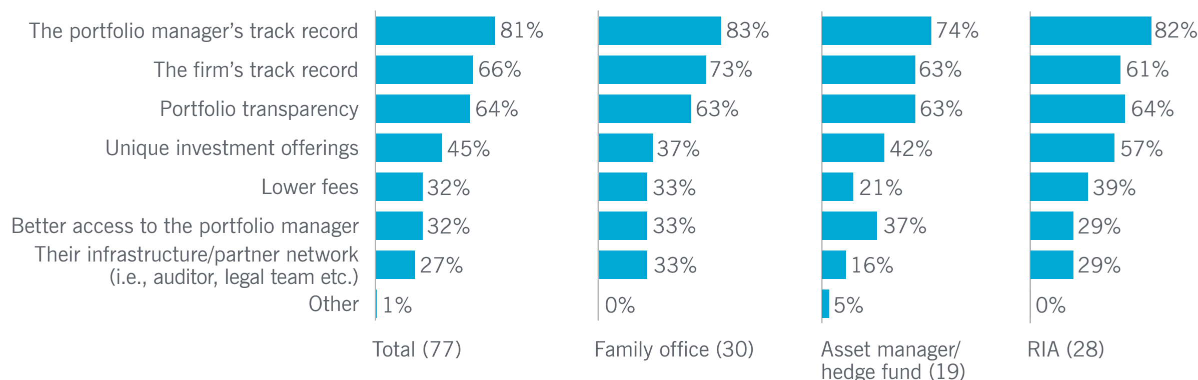
RISK MANAGEMENT: DIVERSIFYING BORROWERS AND LIMITING RISK EXPOSURE

Managing risk is an ongoing priority, one that starts before any potential deal, and goes on after delivery of a loan. We believe the best private credit portfolios function as firewalls for investors when market volatility negatively affects liquid assets. We also understand investors are best served through a well-diversified portfolio, comprising multiple borrowers that can navigate rate or economic storms reasonably well, and can support consistent returns for investors.

For meaningful diversification, investors should not fall into the myth that bigger is better. Bigger deal sizes often equate to greater leverage and weaker covenant structures, raising the risk of a loan.

OPINION PIECE. PLEASE SEE IMPORTANT DISCLOSURES IN THE ENDNOTES.

Figure 2: Top-three criteria investors use to select credit managers are portfolio-centric



Data source: Coalition Greenwich 2023 Private Credit Market Structure Study. https://www.greenwich.com/market-structure-technology/wealth-and-asset-managers-focus-private-credit

Limiting risk exposure through deal size is only one aspect of risk management. Much of the work to sift out weaker opportunities will have been done before any potential deal. However, private credit managers should be protecting investors where possible following the completion of a deal, having processes in place to identify changes in portfolio companies.

This can be as simple as managers regularly revisiting KPIs or covenant tightness to gain insight into a company's health. Similarly, understanding how different macro environments will affect portfolio companies will help maintain investments.

For investors, it is important that managers maintain oversight of portfolio companies after a loan is finalized and have the ability to identify risk indicators and the ability to act in a way that minimizes losses.

Just as not all private credit is equal, not all managers can deliver on investor needs.

USING MANAGERS TO MAXIMIZE PRIVATE CREDIT

Private credit managers can play a pivotal role in unlocking opportunities for investors. However, as the market becomes increasingly important to well-diversified portfolios, it is important to keep in mind that not all deals are of the same quality.

Investors entering the space for the first time, or expanding allocations to private credit, may consider using a private credit manager as the best route to maximize opportunities. However, it is important to select a manager that demonstrates an ability to identify quality borrowers in specific market segments early on. Managers should also have the knowledge to scrutinize borrower performance and business model health, along with the experience to know how best to price a deal and to continue analyzing a borrower's status after a loan is finalized.

Just as not all private credit is equal, not all managers can deliver on investor needs. Managers who will best serve investors in private credit will likely be able to match opportunities to an investor's risk parameters, secure attractive terms and pricing, and effectively react to changing conditions of portfolio companies.

OPINION PIECE. PLEASE SEE IMPORTANT DISCLOSURES IN THE ENDNOTES.

Q&A

Brent Chase

Managing Director,
Head of Workouts

Experienced private credit managers keep watchful eyes on portfolio companies. Their practices aren't flashy but rely on methodical monitoring and reporting, beginning with some version of credit surveillance reports (CSRs).

No matter how diligent top direct lenders are in using best practices, losses happen. In fact, we expect loss events will occur and prepare for those eventualities.

In a recent conversation, Churchill's head of workouts, Brent Chase, offered his secrets for successfully managing troubled portfolio financings.

"First, you have to remain proactive as a lender. Advocate the direction you want to go to other capital providers, owners and management. Otherwise, you'll be reacting to the strategy and direction of others, which can result in sub-optimal outcomes."

"Workouts require hands-on monitoring. Cash flows are more 'fragile.' A relatively minor performance miss can have significantly negative liquidity implications. Spotting deviations early and communicating closely with the borrower allows time to deal with issues like cash shortfalls quickly. In our case, LP investments in numerous sponsor funds allow us to engage in more meaningfully direct and active dialogue with sponsors in tough scenarios."

Chase continued, "developing relationships with key capital structure constituents can help you understand their motivations and behaviors. Whether you're developing coalitions with like-minded lenders within your class, or reaching agreements with other capital structure constituents, work the phones! Those new to private credit may not appreciate the 'clubby' nature of the traditional middle market. Having long histories with lender friends in various parts of the capital structure greatly helps outcomes."

"Most middle market workouts don't end up as 'free-fall' Chapter 11s. Consensual workouts generally result in the best outcomes and recoveries. To accomplish this, you need to do business with sponsors with strong track records of supporting their problem portfolio credits."

How do you begin your workout process? "Our team re-underwrites each troubled name. You need to understand why the company deviated from its expected path in the first place. Start with a clean slate. Is it fixable? Often the original credit risks (or strengths, for that matter) are no longer relevant. Maybe it's unforeseen changes in the company, industry or macro environment. By re-underwriting the business, you can begin to get a handle on the new headwinds and tailwinds impacting performance today and in the future.

"Workout fatigue is a real thing. It's tempting to dismiss businesses as 'broken.' But the 'good company, bad balance sheet' thing is also real. You need to be patient and work through the operating challenges methodically. Having a dispassionate view on what aspects of the business model are still valid will significantly influence the steps you take to maximize value recovery."

Spotting deviations early and communicating closely with the borrower allows time to deal with issues like cash shortfalls quickly.

OPINION PIECE. PLEASE SEE IMPORTANT DISCLOSURES IN THE ENDNOTES.

For more information, please visit nuveen.com.

Endnotes

This material is not intended to be a recommendation or investment advice, does not constitute a solicitation to buy, sell or hold a security or an investment strategy, and is not provided in a fiduciary capacity. The information provided does not take into account the specific objectives or circumstances of any particular investor, or suggest any specific course of action. Investment decisions should be made based on an investor's objectives and circumstances and in consultation with his or her financial professionals.

The views and opinions expressed are for informational and educational purposes only as of the date of production/writing and may change without notice at any time based on numerous factors, such as market or other conditions, legal and regulatory developments, additional risks and uncertainties and may not come to pass. This material may contain "forward-looking" information that is not purely historical in nature. Such information may include, among other things, projections, forecasts, estimates of market returns, and proposed or expected portfolio composition. Any changes to assumptions that may have been made in preparing this material could have a material impact on the information presented herein by way of example. **Past performance does not predict or guarantee future results**. Investing involves risk; principal loss is possible.

All information has been obtained from sources believed to be reliable, but its accuracy is not guaranteed. There is no representation or warranty as to the current accuracy, reliability or completeness of, nor liability for, decisions based on such information and it should not be relied on as such. For term definitions and index descriptions, please access the glossary on nuveen.com. **Please note, it is not possible to invest directly in an index.**

Important information on risk

Investing involves risk; principal loss is possible. Debt or fixed income securities are subject to market risk, credit risk, interest rate risk, call risk, derivatives risk, dollar roll transaction risk and income risk. As interest rates rise, bond prices fall. Below investment grade or high yield debt securities are subject to liquidity risk and heightened credit risk. Foreign investments involve additional risks, including currency fluctuation, political and economic instability, lack of liquidity and differing legal and accounting standards. Please note investments in private debt, including leveraged loans, middle market loans, and mezzanine debt, are subject to various risk factors, including credit risk, liquidity risk and interest rate risk.

This information represents the opinion of Nuveen, LLC and its investment specialists and is not intended to be a forecast of future events and or guarantee of any future result. Information was obtained from third party sources which we believe to be reliable but are not guaranteed as to their accuracy or completeness. There is no assurance that an investment will provide positive performance over any period of time.

Nuveen, LLC provides investment solutions through its investment specialists. Churchill Asset Management is a registered investment advisor and an affiliate of Nuveen, LLC. This information does not constitute investment research as defined under MiFID.

Notice to persons in ADGM: This material is issued by Nuveen Middle East Limited ("NMEL") in or from Abu Dhabi Global Market ("ADGM"). NMEL is a private company limited by shares established in ADGM and registered with the Abu Dhabi Global Market Registration Authority (ADGM Registered Number 18132), with its office at Unit 16, Level 7, Al Maryah Tower, Abu Dhabi Global Market Square, Al Maryah Island, Abu Dhabi, United Arab Emirates.

1810753
3948713-0926

CHURCHILL
from nuveen