CHURCHILL
from nuveen

First quarter 2022

Full speed ahead: Private credit outlook 2022

As investment managers reflect on an incredibly productive 2021, many are now looking ahead to 2022. What will the new year bring?

Two years ago, no one could have foreseen the imminent downturn or the agent that caused it. Nor one year ago were the courses of the pandemic, vaccines, or bull-run of public equities predictable.

So we approach forecasts with a measure of caution, but having witnessed remarkable private credit performance over the past 24 months, we feel comfortable highlighting key themes around the outlook for next year.

- **Activity levels.** 2021 was characterized by the unleashing of pent-up private credit demand from issuers and investors. Some was a response to catching up from 2020's stuck-at-home dynamics. But a lot was attributable to the virtues of the asset class highlighted by the pandemic: relative yield, less correlation and lower defaults. Will these benefits hold in 2022, or weaken from competitive pressures?
- **Portfolio construction.** Choosing the right sectors is always critical to manager performance, but particularly since 2020. Private credit portfolios in consumer-facing businesses got swept into whatever path COVID sent them. Many B2B companies overcame infection worry and rode on an economic surge. How will selectivity and diversification affect future defaults and recoveries?
- **Mega-tranche trend.** Disintermediation to direct lenders away from broadly syndicated loans (BSLs) accelerated this year. We saw a rise in vehicles that were $1 billion-plus unitranches, often with bond-like (cov-lite) covenants and high leverage. In many cases, the borrowers were large-cap software buyouts sporting sky-high purchase price multiples. As deal sizes grow, will more paper be distributed? Will the buy side start looking like the sell side?

- **Inflation and interest rates.** All eyes have been on interest rates and rising inflation. Now that the Fed's intentions have firmed, the question is simple: Will the pandemic-induced spike in prices for goods and services ease as supply/demand forces rebalance, or has COVID fundamentally changed the true cost of things? And what will higher (or lower) growth do to interest rates?
- **Does ESG matter?** In 2021, interest in ESG factors penetrated into every corner of the market. As a driver in both investor and manager behavior in the asset management sphere, the trend has created both opportunities and challenges. Will political pressure surrounding ESG motivate real change or defensive box-checking – so-called "greenwashing" – that is more form over substance?

What will deal activity look like in 2022? One thing is for sure, it will be hard to beat 2021.

THE MOST ACTIVE PRIVATE CREDIT MARKET EVER

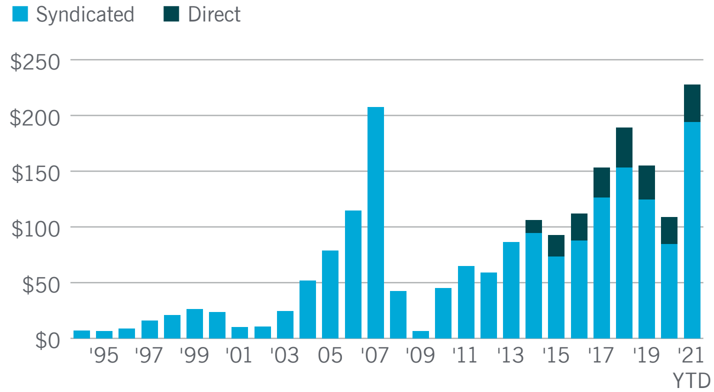
S&P LCD noted in mid-November that, high-yield bond and leveraged loan issuance set a new annual high of $1 trillion. Also, junk bond AUM topped $1.5 trillion. And the total leverage finance market surpassed $3 trillion. In the private credit sphere, combined syndicated and direct loans set a record of $228 billion, topping 2007's BSL-only mark.

Several causes contributed to this run-up. There's recognition that broad swaths of the economy, particularly B2B industries, are in great shape. The Fed has vowed to keep rates at rock-bottom until employment returns to pre-COVID levels, and ideally until their bond-buying taper is concluded. Assuming inflation remains contained.

Fueling liquid credit volume is insatiable appetite from CLOs and retail funds. The former has seen

Exhibit 1: Record-setting activity

U.S. LBO loan volume (U.S. $bil)



Source: Refintiv LPC

Past performance is no guarantee of future results.

record vehicle formation – over 320 launched totaling more than $160 billion – while the latter enjoyed $30 billion in cash inflows so far this year (vs. $20 billion in 2020).

On the direct lending side, private credit managers remain bullish for the upcoming year. A huge driver is the timing of private equity fundraising. Sponsors had dry powder from 2019 and 2020 campaigns, but COVID impacted deployment. The pipeline of transactions grew and has been streaming out ever since.

When will deal flow normalize? We believe that there's plenty of backlog keeping buyers and finance partners busy through the first half of 2022. After that is more of a question. Variables like interest rates, inflation and the mid-term elections will all impact activity levels. But even if the Fed begins to tighten, that's a plus for floating rate assets.

Market hiccups rarely slow demand for private credit since they generally lead to more favorable investor terms. On the flip side, the status quo is good for LPs hoping to put capital to work quickly. Either way, the outlook for continued strong activity in both public and private credit remains favorable for next year.

SELECTIVITY AND DIVERSIFICATION WILL DRIVE PORTFOLIO STRATEGY

Portfolio construction has been a key determinant in success over the past two years.

Consumer-facing sectors had a rough time early on, but new patterns were quickly established. The toll on small retailers, particularly restaurants, was devastating. Defensive B2B businesses managed better, and in some cases, thrived. Post-vaccine regimes supported the consumer side as people edged back to work.

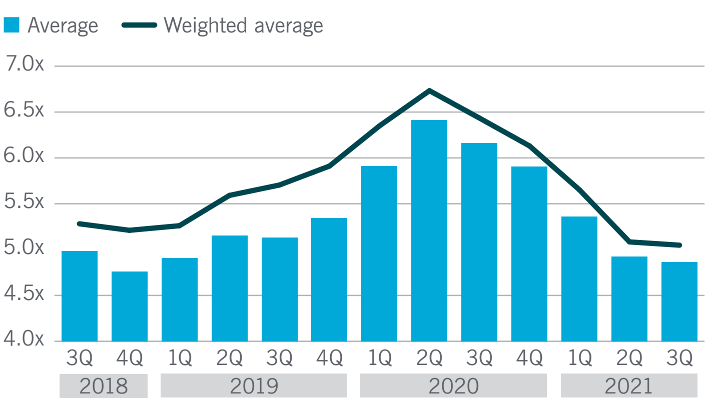
Today, almost two years on, crosscurrents are still at work. The Omicron variant threatens to upset reopening scenarios globally, roiling capital markets. And there is no end in sight for the virus.

Of more immediate concern to portfolio managers are continuing supply chain issues. Getting goods from point A to B is a systemic challenge. Services similarly are hampered by labor shortages.

Revenues are up for large corporate borrowers in the S&P/LSTA Leveraged Loan Index, driving leverage to a record low. Even for those able to pass higher costs along, the pace of price increases has created a drag on profitability. That demands closer attention by managers to monthly performance.

Exhibit 2: Record low leverage

Average leverage — outstanding U.S. leverage loans



Data through 30 Sep 2021.
Source: S&P Leveraged Commentary & Data (S&P/LSTA US Leveraged Loan Index)

Even companies that received COVID subsidies bear watching. With current funds demanding realizations, sponsors are compelled to recap portfolio companies, leveraging EBITDA above pre-pandemic levels. What happens when "normalized" conditions return? Performance resets (up or down) may not be clear in all cases, leaving managers with tough credit decisions.

Beyond selectivity experienced lenders demand diversification, even within defensive sectors such as healthcare, business services, technology and software. As the last two years proved, expecting the unexpected preserves cushion for errors. Ensuring borrowers have sufficient liquidity to withstand product or service interruptions helps bridge the bumpy periods.

And most of all, having owners and financing partners aligned to preserve enterprise value will help keep defaults and losses to a minimum, no matter what surprises 2022 has in store for us.

MEGATRANCHES: THE RISE OF THE $1 BILLION+ UNITRANCHE

Back in 2015, it was our observation that direct lenders saw the opening to compete against banks for leveraged finance deals but needed virtual balance sheets to hold larger commitments.

Over time, these managers raised multiple vehicles — CLOs, separate managed accounts, commingled funds, BDCs, etc. — to create loan storage pockets. They could then allocate commitments of size across vehicles without any holding outsized positions.

As pockets were added, hold sizes grew. Over the past six years, direct lenders' average holds expanded from $25-30 million to $100 million-plus. At the same time, the development of the unitranche has given managers a competitive instrument to take share from loan arranging (not loan holding) banks.

In 2017, per Refinitiv LPC, only 28% of unitranches were above $250 million. Today that share is up to 77%. Migrating into the broadly syndicated market requires not just size but also large cap terms. The most significant is cov-lite. We vividly remember not long ago hearing a private credit manager scoff at the idea of a cov-lite unitranche: "Who would do *that*?"

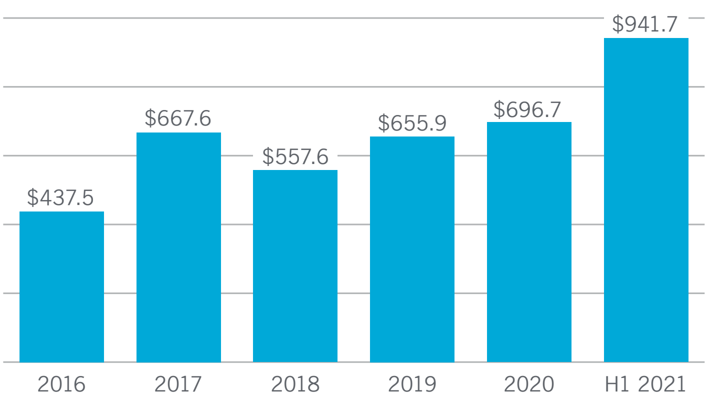
Yet it happened. The largest managers are pocketing $1 billion-plus unitranches, both in the United States and Europe. Besides being highly leveraged, these megatranches sport sky-high purchase price multiples for growth-oriented software companies.

A timely example is Permira's go-private for *Mimecast*. The cybersecurity services deal is just shy of $6 billion, with about $3 billion in financing. This issuer would typically access the BSL market. The managers' likely unitranche structure side-steps the usual syndication process and provides the client certainty of execution.

As Exhibit 3 highlights, the growing size of private debt funds is contributing to what looks to be a trend for the future. Megatranches could reach $5 billion in size before too long, as the largest managers continue to scale.

Exhibit 3: The average fund size dramatically shifted upward in 2021

Average size of private debt funds ($ millions)



Source: Private Debt Investor

What are the implications of these elephant hunts? While most are held among very tight clubs, will managers eventually seek to distribute paper to relationship accounts? Will that entail more of a market approach to terms? In short, will the buy side begin to look like the sell side?

While unitranche activity at $50 billion set a record last quarter (more than double 2Q), it's still far from syndicated loans, which totaled $200 billion. Nevertheless, we expect to see this trend continue in 2022.

> *Nuveen Chief Investment Strategist Brian Nick remains confident the surge of higher prices will ease by the middle of 2022 as supply chains normalize and pent-up demand runs out.*

FACTORS DRIVING INFLATION

Inflation and interest rates are linked, but not always in straightforward ways. Fear of higher prices can drive rates up, while markets may ignore actual inflation having anticipated it. Recent data has certainly created alarming headlines. A cursory look at the facts behind the fever is educational.

The December 10, 2021, CPI report showed November's consumer prices up 6.8% versus last year. Not since 1982 has that metric been as lofty.

Two other factors have come into play: Omicron's emergence, and the Fed's modified hawkish stance. Both the variant's impact on future growth and the central bank's willingness to taper faster for a potentially earlier rate hike have raised the possibility of a future slowdown. These opposing dynamics may potentially send mixed signals to investors and portfolio managers alike.

Today's supply chain issues may lead to tomorrow's gluts. Both product and service shortages are resulting in increased production as raw materials and labor come online. Even if some demand is sustained, that ramp could create excess inventories, and prices tumble. Lumber was a recent example of this phenomenon.

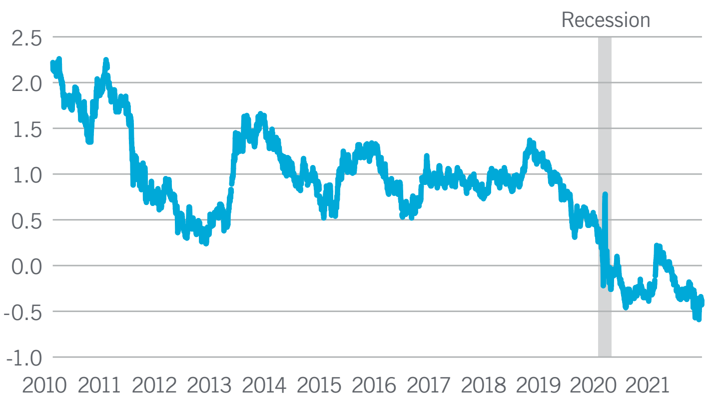
All of this presents a confusing picture for investors. While "transitory" may have been discarded from the Fed's lexicon, that hasn't clarified the inflation outlook.

In the meantime, long-term Treasury rates flattened in response to more virus and faster hikes. The short end of the curve seems convinced that "faster" doesn't mean anytime soon.

Exhibit 4 shows higher inflation has driven real U.S. Treasury yields to their lowest levels on record. Given that dynamic, investors seeking to hedge against eroding buying power will find insurance expensive.

Exhibit 4: Record low yields

Long-term inflation protected Treasury yields



Data through 23 Dec 2021
Source: Federal Reserve Economic Data

However, investors can access assets less negatively correlated to higher interest rates or rapid economic growth. Direct lending provides a natural hedge as a floating rate product, but also a current yield at a premium to risk-free rates and more public credit instruments.

And even with three quarter-point rate hikes in 2022, that puts Fed funds at 1%. Hard to pin a slowdown on that.

THE GROWING IMPORTANCE OF ESG

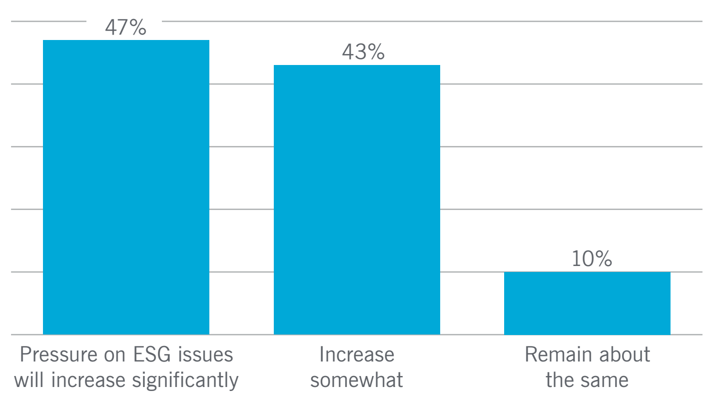
We planned last year to publish a special series on environmental, social and governance, or ESG. Unlike most topics in our commentaries, the origins and complexities of ESG were unfamiliar.

To the rescue came our Nuveen colleagues, a Responsible Investing team of close to 30 ESG professionals. Of course, risk management is core to Churchill's own practice, but the recent refinement of ESG data and insights allows us to enhance our approach to ESG diligence.

As shown in Exhibit 5, ESG is a fundamental concern of investors today. Whether it will become as impactful a motivator of manager behavior will depend on regulation and client demand. But it clearly has landed in the top two or three asset management issues for 2022.

Exhibit 5: ESG Pressure

Asset managers are reporting increased investor focus on ESG matters



Source: IHS Markit Survey, The ESG agenda: Revolution or evolution, 26 Oct 2021

Origins. A cursory review of the record shows ESG in some form has been around for centuries. Early practices were rooted in screening out business activities misaligned with stakeholder values, harming the environment or society. From Mosaic law dating back to 1500 BC, to precepts in the Koran, to Henry VIII's legalization of lending, to 18th century England and the Methodist movement, right up to the 20th century's "socially responsible investing," now referred to as responsible investing.

Current themes. Besides historic influences, climate change, diversity, equity and inclusion, and corporate integrity are now the lens through which investors are assessing managers' ability to understand the associated risks and opportunities for every investment decision.

Disclosure and regulation. Greenwashing (deceptive ESG representation including reporting) is bringing scrutiny from governmental and regulatory agencies. That plus investor demand for transparency is leading to higher disclosure standards for portfolio companies and managers. Regulatory and standards requirements have yet to converge, making implementation and compliance a challenge.

Evolution by asset class. Traditionally, ESG resided in public equity given shareholders' ability to change corporate behavior. The public fixed income market has now adopted and refined ESG datasets and frameworks to mitigate downside risk. Applying an ESG lens in private markets can add value for private equity investors while protecting lenders from default risks. As one asset sales head put it, "…lenders working together and influencing the decisions of companies is key for improving on ESG."

Screening vs. selections. A manager's process places them on a spectrum from negative screening, which is more of a "box-checking" approach, to actively seeking out companies which are strategically managing their ESG risks and opportunities.

ESG outlook for private credit. Responsible investing is both "a world under construction," as one expert wrote, and a long-time practice. "I have been doing ESG for 27 years; I just didn't know it," a top CLO manager remarked. We expect investors' demand for more clarity around ESG decisions and performance will further refine metrics and benchmarks for private credit managers as the year progresses.

For more information, please visit nuveen.com.

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