PRIVATE CREDIT

Russell Investments

WHY NON-PROFITS SHOULD CONSIDER PRIVATE CREDIT

Alternative investments have become a more prevalent aspect of multi-asset investing. Moreover, non-profits are increasingly using alternatives to help address some of the **key challenges they face in managing their investment programs**, such as achieving a desired return to support their spending and managing risk at the total portfolio level.
In this article, we'll look specifically at private credit and consider the growth in private credit markets, the potential benefits it can deliver to investors, and the impact of adding private credit to the asset mix for the **investment programs of non-profits**.

A growing opportunity set

Providing loans to companies has historically been one of the main components of commercial banking activity. However, bank consolidations that began in in the mid-1990s and regulations that followed the 2008 Global Financial Crisis (i.e., Dodd-Frank, Basel III) have led to reduced lending activity to small- and medium-sized companies. And while traditional financing sources have retrenched, capital from private credit funds has filled the void, marking a decade of significant growth, with total private credit assets under management (AUM) rising from $237.9 billion at the end of 2008 to $848 billion at the end of 2020. Private credit AUM is expected to grow even further over the next several years, reaching a projected $1.46 trillion at the end of 2025.[1]

Private credit comes in many forms, but most commonly involves non-bank institutions making loans to private companies, based on the cashflows generated by the respective business, for the acquisition of a hard asset (e.g., real estate) or acquiring existing loans on the secondary market. Examples of different types of loans include:

- **Senior debt** – a loan that will be repaid first if the borrower defaults
- **Subordinated debt** - a loan that is repaid after senior debt in the event of bankruptcy
- **Unitranche debt** – senior and subordinated debt combined into one loan
- **Mezzanine** – a form of financing that combines debt and equity

The investment rationale

We believe private credit offers non-profits distinct investment benefits, including:

1. Superior performance potential relative to public fixed income

Private credit has outperformed its public counterpart (Credit Suisse Leveraged Loan Index) in 20 of the last 20 vintage years by an average of 5.48%, according to data from Hamilton Lane.[2] The current market environment also highlights the potential for outperformance on a go-forward basis given the available risk premiums in direct U.S. middle market loans, which is estimated to be between 2.3% and 3.4% above that of broadly syndicated loans.[3]

2. Portfolio diversification

Private markets represent a large investable universe. For example, in the U.S. there are over 17,000 private companies with annual revenues over $100 million, vs. approximately 2,600 public companies with the same revenues. By this measure, investors only allocating to public markets are limiting their opportunity set to just 15% of the largest firms in the U.S.[4]

Private credit offers less volatility relative to public fixed income, such as bank loans and high yield, given that loans are not publicly traded and are typically valued on a quarterly basis. As such, they are not subject to the technical market moves experienced by investments with daily mark-to-market pricing.

Private credit also offers investors greater downside protection as loans are typically higher in the capital structure and have strong covenants that include lender protections requiring companies to meet certain financial conditions—such as debt/EBITDA or interest coverage ratios.

Private credit also offers investors greater downside protection as loans are typically higher in the capital structure and have strong covenants that include lender protections requiring companies to meet certain financial conditions—such as debt/EBITDA or interest coverage ratios. Even in the event of default, the average recovery rate for U.S. middle market senior loans between 1989 and 2018 was 75%, which was significantly higher than the 56% recovery rate for senior secured bonds.[5]

Finally, in times of negative calendar year returns seen in high yield markets, such as 2008, 2015 and 2018, data shows that the Cliffwater Direct Lending Index outperformed the Bloomberg Barclays High Yield Index by an average of 13.26% each year.[6]

3. Shorter lifespan relative to private equity

The shorter average lifespan of private credit investments relative to private equity results in a quicker investment period and return of capital (often within a two-to-six-year window). As such, investors who may be subject to liquidity constraints can still gain the benefits of private markets exposure without having to invest in funds that have a 10-year term, as is the case with private equity.

4. Floating rate coupons

Generally speaking, the interest rate paid on private credit loans are floating rate and as such will increase as interest rates do, consequently providing protection from rising interest rates.

Case study: Impact of adding private credit

When considering the addition of private credit investments in a portfolio, it is important for investors to understand the impact on key metrics such as total portfolio expected return, volatility, and worst-case return scenarios. In Exhibit 1, we summarize the impact of adding a 10% allocation to private credit to the portfolio of a typical non-profit.

Exhibit 1: Impact of adding 10% private credit allocation to a non-profit portfolio

	PORTFOLIO A: 65% GLOBAL EQUITY I 35% CORE BONDS	PORTFOLIO B: 65% GLOBAL EQUITY I 25% CORE BONDS I 10% PRIVATE CREDIT	PORTFOLIO C: 60% GLOBAL EQUITY I 30% CORE BONDS I 10% PRIVATE CREDIT
Expected return	6.11%	6.65%	6.38%
Volatility	10.43%	10.47%	9.70%
1-in-20 worst case return	0.22%	0.81%	0.98%

In Portfolio B, the addition of private credit (which was funded 100% from core bonds) resulted in an increase in expected return from 6.11% to 6.65%, an increase in volatility from 10.43% to 10.47% and a 0.59% improvement in a 1-in-20 worst-case return scenario. On balance, the addition of private credit results in a higher return with similar levels of volatility compared to the original portfolio with no private credit exposure.

In Portfolio C, the addition of private credit (which was funded 50% from core bonds / 50% global equity) resulted in an increase in expected return from 6.11% to 6.38%, a reduction in volatility from 10.43% to 9.70% and a 0.76% improvement in a 1-in-20 worst-case return scenario. In this instance, the addition of private credit provides both higher returns and reduced volatility.

The bottom line

As non-profits seek to address the challenges in managing their investment programs, such as achieving a desired return in line with their spending rate and managing risk at the total portfolio level, some are increasingly looking to utilize private credit in their asset allocation.

Ultimately, while each non-profit’s circumstances are different—and there is no one-size-fits-all solution—we believe it is a worthwhile exercise for investors to consider allocations to private credit to improve potential outcomes.

[1] The Rise of Private Credit: Who, What, Where and Why, July 2020; S&P Global Market Intelligence, November 2020
[2] Hamilton Lane, March 31, 2021
[3] Cliffwater 2021 Q2 Report On U.S. Direct Lending, June 30, 2021
[4] Hamilton Lane, Broader Horizons: The Case for Private Markets Investing, April 2021
[5] Oaktree Insights, Direct Lending: Benefits, Risks, and Opportunities, May 2021
[6] *Cliffwater 2021 Q2 Report on U.S. Direct Lending, June 30, 2021*

QUESTIONS?

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