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Private Credit: Is the Juice Worth the Squeeze?

MILL CREEK

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Executive Summary

In this publication, **Nora Pickens**, Partner, Investment Strategy, analyzes the risk and return profile of private credit versus public fixed income markets. While private credit offers higher potential returns due to its illiquidity and long-term holding strategy, it demands careful risk management. The starting yield is the primary factor driving returns. Historical data indicates that lower-rated debt (B and CCC) often fails to justify its higher risk, leading to significant losses during economic downturns.

- 1 Private Credit vs. Public Debt:** Private credit has grown significantly since 2008, filling a gap left by traditional banks. However, its shorter track record limits understanding of long-term risks.
- 2 Yield and Risk:** Private credit may underperform during early stages of downturns, but its higher yields can lead to quicker recovery and better long-term returns when properly priced.
- 3 Manager Selection:** We believe success in private credit depends on choosing managers with strong underwriting and risk management skills.
- 4 Diversification:** In our view, effective diversification across sectors, geographies, and strategies is crucial to mitigate risks, especially during concentrated default cycles.
- 5 Conservative Yield Targeting:** We believe investors should avoid stretching for higher yields to protect capital and achieve steady, long-term returns.
- 6 Market Vigilance:** In our view, it is important to monitor capital flows and reassess assumptions when risk premiums compress to maintain a strong investment strategy.

Fixed income is not a box of chocolates. You almost always know what you're going to get.

The main driver of returns for debt investors is the starting yield. Yield incorporates both the coupon and premium/discount of debt to par. For instance, a 5-year bond with a 5% coupon trading at \$90 has a 7% yield. The investor earns the annual 5% coupon plus 10% as the bond nears maturity (realized total return might incur small deviations from the starting yield based on the interest earned from reinvested coupons and timing of principal paydown). But any significant gap between invested yield and final return indicates one thing: investors received back less than par value at maturity. This event is known as a “haircut” or partial default.

Partial defaults usually occur when a borrower unexpectedly encounters a roadblock that stresses their business and cash flow, like COVID, the global financial crisis, a regulatory change, or poor operational execution. Either way, revenues that were forecasted to reach certain levels become impaired, the company has difficulties making interest payments, and it eventually defaults on its debt obligations. Lenders will do their best to recover losses, but the amount of principal that is paid back varies depending on collateral value. Any haircut on principal reduces an investor's return and leaves a portfolio with less capital to reinvest going forward.

One way to minimize the potential risk of a haircut is by simply investing in companies that use less leverage. A stronger balance sheet provides a buffer to businesses when these downside scenarios occur, leading to a higher likelihood of moving through the period unscathed.

There is a relatively strong relationship between the starting yield and forward-looking return for corporate bonds rated AA through BB. Correlations are in the 70% to 90% range for most bonds and the difference between starting yield and annualized

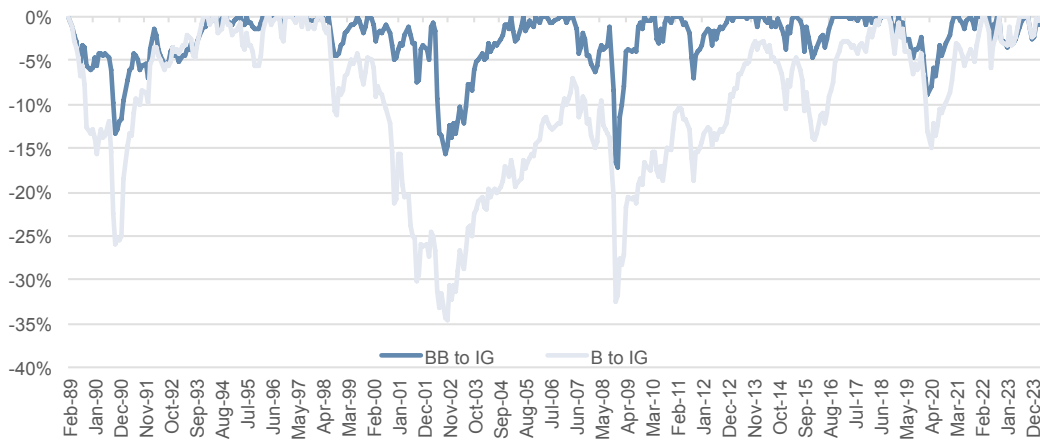
Nationally recognized statistical rating organizations (NRSROs), including Fitch, Moody's, and Standard & Poor's, assign ratings to debt securities based on default risk, or the likelihood that principal and interest will not be paid in full. Ratings are based on a graded scale. High-quality securities fall into the “investment grade” category which includes AAA, AA, A, and BBB ratings. Riskier debt investments are known as “high yield” or “junk” and assigned BB, B, CCC, CC, or a C rating. Globally, investment-grade corporate debt represents 78% of the market. Investment-grade borrowers tend to be larger organizations with revenues that can support a greater quantum of debt even though their leverage profile is lower than high-yield companies.

Fig. 1: Fixed income return characteristics, 1999–today

	Annualized return	Sharpe ratio	Average yield	Difference	Correlation: yield vs. return
AA	4.3%	0.59	3.5%	0.8%	88.3%
A	4.7%	0.46	3.9%	0.7%	83.4%
BBB	5.4%	0.53	5.3%	0.1%	70.3%
BB	7.0%	0.67	6.5%	0.4%	67.7%
B	5.7%	0.42	8.1%	-2.5%	51.2%
CCC	5.7%	0.28	12.5%	-6.7%	47.5%

Source: Bloomberg, Mill Creek.

Fig. 2: Drawdown of BB and B corporate debt vs. investment-grade corporate



Source: Bloomberg, Mill Creek.

return is less than 80 basis points. However, a noticeable break occurs at the B rating category. There is a steep drop-off in correlation between yield and realized return. Specifically, the delta between return and yield for B and CCC debt is -250 bps and -670 bps, respectively.

The lowest-rated companies are the most likely to miss debt payments. They have weaker business profiles and higher leverage, generally above 6x debt to EBITDA in the B and CCC categories. The combination makes them vulnerable to defaults and ultimately double-digit losses on their debt.

Investors expect higher returns for higher-risk investments. For the most part, this plays out across the fixed income universe: A-rated companies return more than AA, BBB more than A, BB more than BBB. But notably, the data above suggests that credit spreads associated with B and CCC companies have not historically been wide enough to compensate investors for the additional risk taken. They produce a less attractive risk adjusted return than their higher-rated peers over longer-term cycles because

significant defaults and permanent loss of principal takes place at some point in the economic cycle. However, the data also suggests that investors don't need to limit their portfolios to only the most pristine balance sheets. By just sidestepping the very lowest-quality borrowers, higher-yielding securities should still lead to favorable outcomes over time.

Why quality matters more in private debt

The key distinction between public and private debt is liquidity. Public fixed income securities are assigned nine-digit Committee on Uniform Security Identification Procedures (CUSIP) numbers, which facilitate daily trading in the secondary market. This systematization means that public debt managers can change their mind and buy or sell securities within their portfolio.

Private debt investors face a different reality. Because there is no established market for exchange, loans are underwritten with the presumption that they are held to maturity. Private debt is implicitly a buy-and-hold strategy. Investors receive an "illiquidity premium" in exchange for this inflexibility, but the permanence means underwriting must account for a wide range of downside scenarios. It's partially why private managers are so keen on targeting noncyclical companies, negotiating robust covenant packages, and structuring tight deal documents. Establishing significant protections from the start leads to better outcomes when challenges arise.

Is private debt worth it?

This paper focuses on one segment of the private debt market due to limitations in data availability. We chose the Cliffwater Direct Lending Index (CDLI) because it is the longest-running index among all private debt benchmarks and captures performance data from a broad range of directly originated loans to middle-market US companies. That said, our private debt program primarily concentrates in niche, asset-backed investments within the fragmented US lower middle market, with only a small allocation to securities similar to those in the CDLI. Nonetheless, this analysis highlights the advantages and reinforces our focus on prioritizing a higher grade of credit risk and not just yield.

The public default data we highlighted above provides valuable insights to private debt investors. Although the private debt asset class has existed for decades, it has only truly gained traction post-2008 when regulations like Dodd-Frank made it more challenging for banks to operate lending platforms. Private managers stepped in to fill the capital void and the asset class has grown markedly ever since.

CDLI has data reconstructed back to 2004, capturing loss rates from the global financial crisis. However, the index tracked assets valued at just \$12 billion in 2008, compared to \$377 billion today. As such, historical data provides only limited insight into how the space might prevail currently under a longer-term shock to the system.

The public data we highlighted in Fig. 1, which represents a much larger market spanning 25 years and three recessions, provides some clues especially as it relates to the outperformance of higher-quality high yield. When peeling back the onion to understand the driver, the 2000–2004 default cycle provides the answer. This was a period that turned out to be even worse for high-yield credit investors than the global financial crisis. A combination of events including the tech bubble, broad economic weakness, and 9/11 created one of the worst periods for high-yield investors on record. For three consecutive years – 2000, 2001, and 2002 – B-rated companies had an elevated default rate that exceeded 6%. CCCs' default rates exceeded 30%.

Defaults normalized in 2004, but the damage was done. A permanent and significant loss of principal put an irreversible hole in lender returns. As we highlighted above, single B and CCC returns are still trailing higher-quality debt more than two decades later (Fig. 3). We emphasize this period because it's an informative stress case that can be applied to the private debt asset class. We should be prepared for another prolonged default cycle, like the one that occurred from 2000 to 2004, and assume the

Fig. 3: Default rates by credit rating

	AAA	AA	A	BBB	BB	B	CCC/C
2000	0.0	0.0	0.4	0.4	1.7	8.5	42.2
2001	0.0	0.0	0.3	0.5	2.6	11.8	50.6
2002	0.0	0.0	0.0	1.3	2.5	6.2	34.6
2003	0.0	0.0	0.0	0.0	0.9	4.1	36.1
2004	0.0	0.0	0.2	0.0	0.6	1.6	20.5
2005	0.0	0.0	0.0	0.1	0.4	2.4	11.1
2006	0.0	0.0	0.0	0.0	0.4	0.7	16.2
2007	0.0	0.0	0.0	0.0	0.4	0.1	16.9
2008	0.0	1.0	0.8	0.7	1.1	4.1	31.4
2009	0.0	0.0	0.2	0.6	0.9	11.1	50.4
2010	0.0	0.0	0.0	0.0	0.0	1.2	23.2
2011	0.0	0.0	0.0	0.1	0.0	1.8	17.2
2012	0.0	0.0	0.0	0.0	0.0	1.1	31.2
2013	0.0	0.0	0.0	0.0	0.0	0.9	29.4
2014	0.0	0.0	0.0	0.0	0.0	0.6	26.3
2015	0.0	0.0	0.0	0.0	0.2	2.4	31.0
2016	0.0	0.0	0.0	0.0	0.6	3.8	42.0
2017	0.0	0.0	0.0	0.0	0.2	1.1	27.9
2018	0.0	0.0	0.0	0.0	0.0	0.5	29.4
2019	0.0	0.0	0.0	0.3	0.0	1.3	32.1
2020	0.0	0.0	0.0	0.0	1.3	3.6	48.7
2021	0.0	0.0	0.0	0.0	0.0	0.5	8.8
2022	0.0	0.0	0.0	0.0	0.2	0.7	12.8
2023	0.0	0.0	0.0	0.3	0.0	1.3	34.6
Average	0.0	0.0	0.1	0.2	0.6	3.0	29.4

Source: Standard & Poor's.

Cliffwater Direct Lending Index, which exhibits many similarities to the liquid high-yield B-rated market, will sustain comparable losses. But what does this mean from a return perspective? *Do private loans adequately compensate investors for this risk?*

To answer these questions, we have modeled out a 10-year period that encounters a 2000-like default cycle using today’s market characteristics (Fig. 4). A few very simple assumptions used in our calculations are outlined below:

Private debt market

- 11.9% starting yield (current yield to maturity of CDLI) year one, continuing throughout the model
- Default rate mirroring single B high-yield companies in 2000–2003 in years 1–4
- 40% principal recovery rate
- Credit spreads unchanged throughout the entire 10-year period (for ease of analysis)

Liquid B high-yield bonds

- Assumptions mirroring private debt market except starting yield is 7.4% (current yield to worst)

Liquid BB high-yield bonds

- 6.3% starting yield
- Default rate mirroring single BB high-yield companies in 2000–2003 in years 1–4

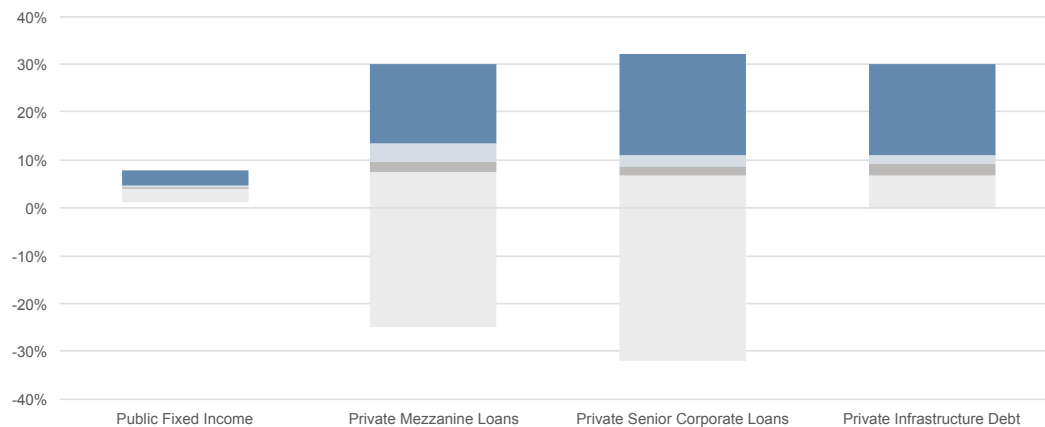
As shown in the table, the private debt index trails the liquid BB market during the early years, but the private sector’s higher income profile provides a quicker recovery than its B-rated liquid counterpart. This is an important takeaway. Over time, private debt’s total spread earned over risk-free Treasuries does a much better job compensating investors for the default risk associated with the space than public debt. There will be periods of underperformance, but the “correctly priced” level of excess yield compounds to drive returns higher through a cycle.

Fig. 4: Private debt and high-yield total return

NAV Growth		Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10	
Private credit	\$100	\$107	\$112	\$121	\$133	\$148	\$164	\$183	\$204	\$227	\$253	
Liquid B	\$100	\$102	\$103	\$106	\$116	\$124	\$133	\$142	\$152	\$163	\$174	
Liquid BB	\$100	\$105	\$111	\$116	\$123	\$131	\$139	\$147	\$157	\$166	\$177	
<i>Total return</i>												Annualized return
Private credit		6.8%	4.8%	8.2%	9.4%	11.4%	11.4%	11.4%	11.4%	11.4%	11.4%	9.7%
Liquid B		2.3%	0.3%	3.7%	9.4%	6.9%	6.9%	6.9%	6.9%	6.9%	6.9%	5.7%
Liquid BB		5.5%	5.0%	5.1%	5.8%	6.2%	6.2%	6.2%	6.2%	6.2%	6.2%	5.9%

Source: Mill Creek, Bloomberg, Cliffwater, as of 7/29/24.

Fig. 5: Quartile returns for public and private credit



Source: Morningstar, PitchBook, Mill Creek. Returns from 12/31/2005-12/31/2020.

It's also important to remember that the CDLI and Bloomberg indexes represent market beta. During periods of volatility, certain managers will navigate the landscape better than others. Some will even thrive. While 2001 saw peak defaults for single B companies, the vast majority of borrowers—over 80%—came out unscathed. An active manager's ability to drive excess return is especially true in the private markets (Fig. 5). For debt investors, this means partnering with managers who follow exceptional underwriting and risk management practices will drive better results than the passive benchmarks would suggest.

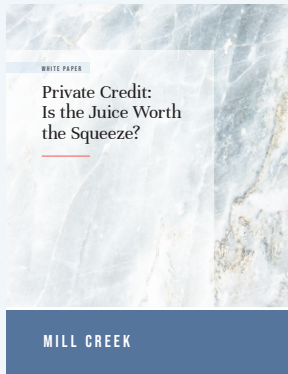
Our positioning

We use this historical data to help guide our allocation decisions across the private debt markets. Three key takeaways include:

- 1) Diversification, Diversification, Diversification:** Default cycles tend to be concentrated in just a handful of sectors. In 2001, 26% of the Telecommunication bond market defaulted compared to only 1.4% of the Healthcare bond market. In 2009, 71% (!) of the Diversified Media universe defaulted compared to just 0.5% for Retail. In 2020, 19% of Energy bonds defaulted versus 1% of Automotives. Without the benefit of a crystal ball, diversification across all vectors including sector, geography, strategy, borrower, manager, etc. is the best defense against the unknown.
- 2) Don't Stretch for Yield:** There is wisdom in the adage "slow and steady wins the race." Hitting singles and doubles over a long period of time proves an excellent way to build wealth. We believe reducing the risk of capital destruction by moving up

in quality is a prudent way to navigate the private debt markets. Unlike in equities, there is no upside to picking the outperformers, so protecting capital in a risk-aware manner needs to be the top priority.

- 3) **Watch the Flows:** An influx of capital to certain areas of the market, whether it be the next “hot” investment strategy, sector, or manager, should not be ignored. Expected returns will naturally decline as risk premiums compress, so taking a step back to reassess assumptions is always a welcome practice.



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This report unveils a new design direction reflecting the evolution of our brand. We hope you'll agree that our updated appearance is a step in the right direction for our reports, presentations, and website. We've particularly focused on elements that improve our visual interface for a more contemporary and engaging look and feel.

As always, we welcome your comments!

Publication details

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See disclosures, next page.

Disclosures

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Regarding Fig. 4, returns presented are hypothetical and not a predictor, projection or guarantee of the future. Returns are for illustrative purposes only and are not based on any MCCA client account or asset allocation strategy. The hypothetical returns are based on the assumptions discussed herein using a 10-year period that encounters a 2000-like default cycle using today's market characteristics. Forward-looking statements involve risks and uncertainties, and there can be no assurance that the forward-looking statements that may be included in this commentary will prove to be accurate. In light of the significant uncertainties inherent in the forward-looking statements included herein, the inclusion of such information should not be regarded as representations or warranties of MCCA and that the forward-looking statements will be achieved in any specified time frame, if at all.

Cliffwater Direct Lending Index ("CDLI")

The Cliffwater Direct Lending Index ("CDLI") seeks to measure the unlevered, gross of fees performance of U.S. middle market corporate loans, as represented by the underlying assets of Business Development Companies ("BDCs"), including both exchange-traded and unlisted BDCs, subject to certain eligibility criteria. The CDLI is asset-weighted and calculated quarterly using financial statements and other information contained in the U.S. Securities and Exchange Commission ("SEC") filings of all eligible BDCs. The loans captured by the CDLI represent a large share of the direct lending universe and, importantly, represent loans that are originated and held to maximize risk-adjusted return to shareholders and investors.

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