MEKETA

Private Credit Primer

WHITEPAPER
APRIL 2024

CONTRIBUTORS
MAYA ORTIZ DE MONTELLANO, CFA
LAUREN GIORDANO
FRANK BENHAM, CFA, CAIA

Key takeaways

→ **Private credit is a form of debt financing offered by non-bank lenders with privately negotiated terms. It has gained prominence and evolved considerably post-financial crisis.**

→ **Private credit strategies fall into four categories: Direct Lending, Asset-Based Lending, Special Situations, and Diversifying. Each strategy has distinct risk and return characteristics.**

→ **Institutional investors may invest in private credit for a variety of reasons, including the potential for higher returns relative to public market credit strategies and lower volatility than public equities. Private credit also offers higher alpha potential than public credit, while potentially offering better downside protection.**

→ **Institutional investors should carefully evaluate fund structures, fees, and manager selection when venturing into private credit. Investing in private credit generally involves managing capital calls and fund distributions. Diversification across strategies is crucial for successful portfolio management.**

Introduction

This primer introduces the asset class commonly known as private credit, or private debt. It attempts to answer the types of questions institutional investors would be likely to ask when considering an investment in this area.

This primer is limited to an overview of private credit. It discusses the characteristics of the asset class and reasons for investing in private credit. It also contains definitions of the major sub-strategies, and it presents an analysis of major return, risk, and implementation considerations for institutional investors. It does not suggest a target allocation, nor does it specify how to implement an investment program. These issues are investor specific and should be addressed by the decision-makers overseeing the allocation.

What is private credit?

Private credit[1] is a loan or other form of debt financing originated by a non-bank lender that is subject to privately negotiated terms. Examples of non-bank lenders are private partnerships (usually backed by asset management firms), pension funds, hedge funds, insurance companies, and sovereign wealth funds. Non-bank lenders are not subject to the oversight of the federal banking system nor are they required to maintain a specified amount of capital reserves against their lending activities.[2] As is common with traditional loans, a wide range of collateral may be associated with private debt, including corporate cash flows, consumer and small business receivables, financial assets such as mortgages, royalties, and intellectual property, or hard assets such as real estate, power generation, aviation equipment, or infrastructure.

Private credit may fill a void left in capital markets by banks and traditional fixed income by providing solutions both to borrowers in search of capital and investors in search of returns. While interest rates for borrowing in private markets are often higher than for public markets, there are compelling reasons as to why borrowers would choose private financing over a public market option. The borrower, often a company or an asset owner, may be too small or lack the credit history or worthiness to raise capital in public markets. Other reasons are speed and certainty in execution, a flexible and tailored structure, as well as confidentiality. The growth of private credit as an asset class has increased the ability of fund managers to compete more directly with liquid capital markets and traditional banks as a source of capital for larger corporate borrowers and asset owners.

[1] Private Debt and Private Credit are used interchangeably in this primer.

[2] Non-bank lenders generally raise capital in closed-end fund structures that do not offer liquidity. This largely removes the potential liquidity mismatch associated with using short-term deposits to make longer term loans.

The evolution of private credit

While private credit has been around for more than two decades, it has evolved such that the market today bears little resemblance to its early days. Prior to the Global Financial Crisis ("GFC"), the private credit universe was composed primarily of mezzanine and distressed debt strategies (see Figure 1). The GFC had a meaningful impact on lending for many years, and private credit was not immune to this. Aggregate capital raised did not return to its 2008 level until 2015. However, it has more than doubled since then, peaking at ~$250 billion in 2021.

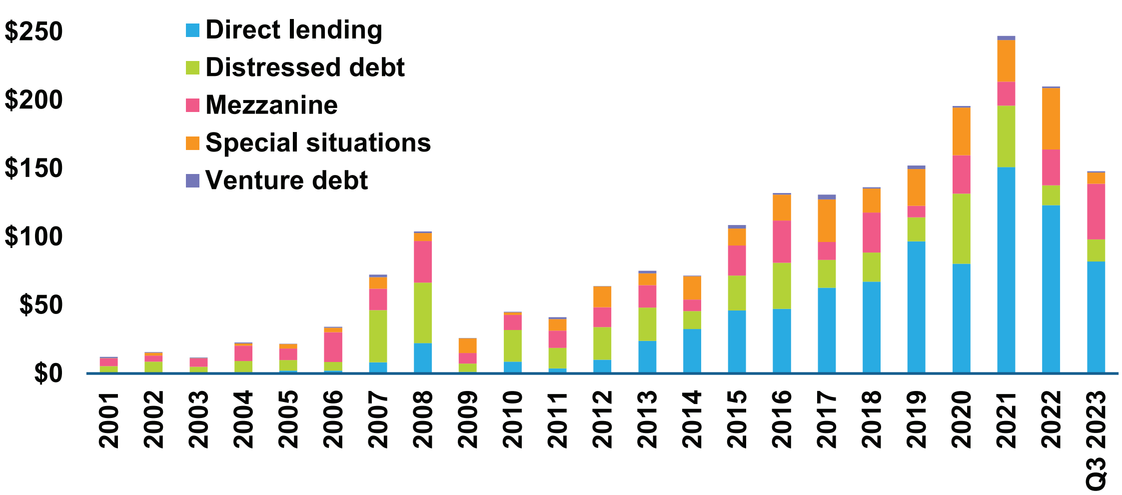

FIGURE 1

Aggregate Capital Raised in Private Credit by Strategy ($B)

Source: Preqin, 2024 Global Private Debt Report published in December 2023. Note: Private debt fund-of-funds were excluded from this chart.

This growth is largely attributed to the supply and demand dynamics that resulted from the fallout of the GFC, as well as software driven technology that eased the burden of connecting borrowers and lenders. On the supply side, increased regulation post-GFC limited the ability of large banks to lend or extend credit to a broad spectrum of economic participants. On the demand side, the increase in the number of investors seeking higher returns in a period of historically low interest rates created demand. Given these dynamics, fundraising and investment increasingly centered around corporate direct lending strategies. As measured by annual fundraising, direct lending remains the largest private credit strategy (see Figure 1).[3]

[3] Private credit financed 65% of leveraged buyouts in 2021 and 85% in 2023. Source: Blackstone, Market Views, November 2023, citing LCD, as of September 2023.

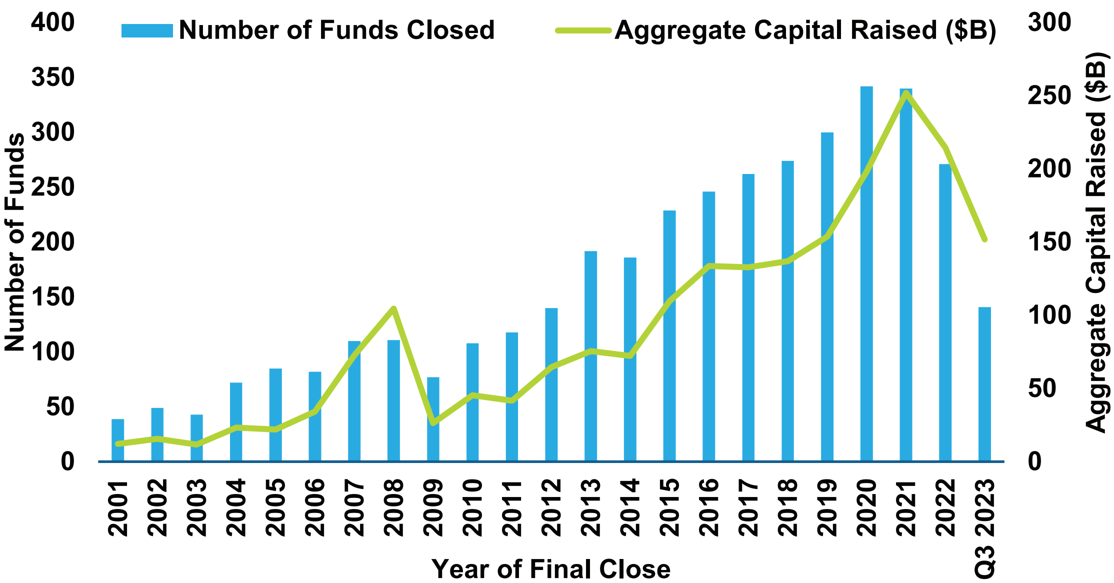

FIGURE 2
Global Private Credit Fundraising

Source: Preqin, 2024 Global Private Debt Report published in December 2023. Note: Private debt fund-of-funds were excluded from this chart.

As of June 2023, the private credit asset class had roughly $1.7 trillion in assets under management.[4] Since 2010, private credit's global aggregate capital raised (by vintage year) has quadrupled in size to roughly $214 billion at year-end 2022 (see Figure 2).[5] Similarly, the number of funds closed increased by roughly 2.5x over the same period.[5] As a result of this growth, private credit recently surpassed real estate to become the second largest private markets asset class behind private equity.[6]

[4] Source: Preqin, as of June 2023. Assets under management refers to both dry powder and unrealized value.

[5] Source: Preqin, 2024 Global Private Debt Report. As of December 2023.

[6] Source: Preqin, as of June 2023. Private Credit became the second largest asset class in private markets as measured by total assets under management for the year 2023, as of June 2023. Private market asset classes include private equity, private credit, natural resources, real estate, and infrastructure.

Private credit strategies

There is no universally agreed upon system for categorizing private credit strategies. Meketa categorizes the private credit universe into four broad groups: Direct Lending, Asset-Based Lending (Specialty Finance), Special Situations, and Diversifying. Within each category, strategies can vary across different dimensions including seniority, target geography, industry, collateralization, and currency, among others. Descriptions of the major strategy groups and primary drivers of their risk and return are provided below.

Direct Lending	Asset-Based Lending	Special Situations	Diversifying
Capital Structure - First Lien - Unitranche - Second Lien - Mezzanine/Junior Debt	**Consumer** - Credit Cards - Student Loans - Auto Loans - Consumer Installment	**Distressed** - Corporate - Mortgage - Commercial Real Estate	- Royalties - Infrastructure - Secondaries - Regulatory Capital Relief
Geography - US - Europe - Asia/Emerging Markets - Global	**Commercial** - Accounts Receivable - Trade Finance - Small Balance	**Capital Solutions** - Rescue Financing - Growth Financing	
Industry - Healthcare - Franchise - Technology	**Hard Assets** - Equipment Leasing - Mortgage Credit - Solar/Renewable Energy - Transportation	**Non-Performing Loans** - Commercial Real Estate - Residential Real Estate - Consumer - Small Medium Enterprises	
	Soft Assets - Intellectual Property - Fund Finance		

FIGURE 3

Meketa's Classification of Private Credit Strategies

Source: Meketa Investment Group, 2024.

Direct lending

Direct lending is the largest segment of the private credit universe in terms of both assets and number of funds. Direct lending is when a non-bank lender provides a corporate loan to a company without the involvement of an intermediary. The proceeds are often used for a strategic activity such as leveraged buyouts, mergers and acquisitions, or add-ons, while the refinancing of pre-existing debt is another common use. Market estimates show that approximately 80% of the direct lending market is sponsor-backed, meaning that the controlling owner of the company is a private equity firm.[7]

Historically, direct lending has tended to focus on the middle market. Currently, that typically means companies with an EBITDA of between $25 million and $100 million. However, the borrower profile is continuing to evolve alongside the broader growth of the asset class, with some borrowers eclipsing $100 million[8] in EBITDA and loan sizes greater than $1 billion.[9]

Direct lending loans are typically senior in the capital structure, which is one of the structural protections of the asset class.[10] The loans typically employ a floating interest rate,[11] with investors earning a spread over the Secured Overnight Financing Rate ("SOFR"). In addition, investors may earn income from other sources, including but not

7 Source: Cliffwater, "2022 Q2 Report on U.S. Direct Lending," September 2022.

8 Source: Meketa observation of direct lending funds.

9 Source: Bloomberg, "Private Credit Loans Are Growing Bigger and Breaking Records." August 2023.

10 Loans can be structured as first lien, second lien, and unitranche. The lien references the claim priority on a company's cash flows and assets. In a default situation, senior creditors have "first claim" (i.e., are the first to be repaid), while holders of subordinated debt have "second claim" (i.e., are repaid only after the first lien investors have been fully paid off). Unitranche debt is a hybrid loan that is structured to combine senior and subordinated debt and can be a preferred instrument for many lenders. Financial covenants are also typical for direct lending.

11 A floating rate refers to an interest rate that adjusts periodically to reflect current interest rate market conditions.

limited to prepayment fees and an original issue discount.[12] Modest leverage (typically 1x debt to equity) is often applied at the fund level, but this can vary widely. For the managers Meketa evaluates, if they use leverage, the range is typically between 0.5x and 2x.

Asset-based lending (aka, specialty finance)

Asset based lending (also known as Specialty Finance) refers to lending activities that seek to generate contractual cash flow and that are backed (i.e., collateralized) by portfolios of financial assets or hard assets. These asset pools typically consist of loans, leases, and receivables. Underlying assets often tie to the consumer (e.g., unsecured consumer loans, auto loans, student loans, credit card receivables), the residential sector (e.g., solar, reperforming loans, development loans), or small business lending (e.g., equipment financing, leasing, accounts receivables, trade finance). The format of the investment varies, such as lending, asset acquisitions, and forward flow arrangements.[13]

One of the key attributes of asset-based lending is the cash flow profile. Unlike direct lending, where much of the cash flow occurs when the loan is retired or re-financed, in asset-based lending, cash flows are more evenly distributed across time. Both the principal and interest are paid back over the life of the loan, and asset-based loans typically do not rely on a realization event. The financing needs for many asset-based borrowers are perpetual, and thus loans are often structured as revolvers.[14] A key differentiation for asset-based lending is that the loan underwriting process considers liquidation value or cash flow generation of the asset as opposed to the credit worthiness and cash flow generation potential of a corporate borrower.

Returns from asset-based lending are largely driven by yield, with select opportunities offering upside potential (e.g., through warrants). As with most other areas in private credit, loans are typically structured to be floating rate. Deals are typically backed by portfolios of assets that are intended to be highly diversified (e.g., in some cases there are thousands of loans) and often have covenants and operational protections.[15] The potential diversification benefits of a broad range of collateral types combined with an attractive return profile may be appealing to many investors.

Special situations

Special situations describes a range of strategies that often involves a greater amount of risk than the other two lending categories, so investors typically seek higher returns. These strategies may focus on providing a customized financing solution or purchasing assets at a discount to their anticipated recovery value.

Special situations lenders often have specialized knowledge of procedural risks that result if a borrower fails to meet their obligation, including legal enforcement, asset management, or restructuring expertise. Assets targeted for purchase are wide-ranging and can include real estate, non-performing loans, and infrastructure, though the largest category is corporate bonds and loans.[16] Assets may be acquired in the secondary market or directly from sellers such a bank, insurance company, or other private partnership.

[12] An original issue discount is the difference between the face value of a loan and its price at the time of issue. It represents an additional amount (of interest) that the lender earns when the loan matures or is paid off, as the lender will receive the full value despite having lent less than the face value to the borrower originally.

[13] Forward flow arrangements are financial agreements where an investor agrees to purchase a group of loans from an originator. This benefits the originator because it provides liquidity that allows them to continue lending without using or raising additional capital.

[14] A revolving loan differs from a term loan in that the borrower has flexibility to draw on the loan like a line of credit and repay at-will instead of having a fixed repayment schedule.

[15] Operational protections are designed to safeguard the lender's interests. For example, assets pledged as collateral may be placed in a bankruptcy remote entity to protect against operating risks associated with the borrower, or minimum cash balances may be required in the borrower's operating bank accounts.

[16] This is based on Meketa Investment Group's observations in the private credit space.

Common sub-strategies of special situations include distressed debt, non-performing loans ("NPL's"), and capital solutions. Distressed debt is often associated with lenders whose debt is trading at a steep discount to face value. Distressed debt may be related to failed mergers and acquisitions, turnaround financing, bankruptcy, and restructuring. NPL's are loans in which the borrower has technically defaulted, often by being more than 3-6 months behind in their payments. Capital solutions describes the origination of debt and/or equity financing to corporate borrowers at various points in their life cycle (i.e., not just when they are at risk of bankruptcy).

Loan structures in this category tend to emphasize flexibility. Loans may include a payment-in-kind ("PIK") feature that typically allows the borrower to defer interest payments by adding them to the principal balance of the loan. Financing structures may exchange straight debt for upside participation, typically in the form of equity or warrants. Compared to the other categories, the primary drivers of return in special situations are more variable between yield and the potential for capital appreciation.

Diversifying

Diversifying strategies refer to a broad bucket that serves as a "catch-all" for private credit strategies that do not fit into the three more traditional categories described previously. Royalty streams, regulatory capital relief, and secondary transactions are part of this group.

In royalty stream investing, an investor provides capital in exchange for a share of the revenue generated from the sale of a product or service. This form of investment is common in industries like music, where artists receive royalties from the sale of their music, or in mining, where a company might receive royalties from the extraction of natural resources. Royalty stream investing can be attractive because it provides a potential ongoing income stream that is based on sales (or downloads in the case of music royalties) that is distinct and separate from performance of the operating company.

Regulatory capital relief investing refers to strategies that regulated financial institutions (e.g., banks) use to manage their capital requirements. This can involve various financial transactions or instruments that help these institutions optimize their capital structure and reduce the amount of capital they must hold against certain assets, thus improving their capital ratios and regulatory standing. In private credit, this strategy often involves originating or participating in a syndicated transaction that contractually transfers a defined portion of risk associated with a collateral pool from the bank to a counterparty for a defined period (typically three to five years) with the bank retaining a significant portion of the risk to align interests. The investment fund effectively backstops losses from this pool of assets.

A unifying attribute across these strategies is that they generally have a key return driver that is not necessarily dependent on economic or corporate growth. This could be demographic trends (e.g., music royalties), regulatory burden (e.g., regulatory capital relief), or discounted entry pricing (e.g., secondaries).

Private credit performance

At a high level, the primary drivers of private credit returns are income and capital appreciation. However, the variety of implementation approaches leads to a range of outcomes across strategies and sub-strategies (shown below in Figure 4). Variables that may impact expected returns include seniority in the capital structure, use of fund level leverage, borrower/collateral quality, structural protections, workout capabilities, and GP experience, among others.

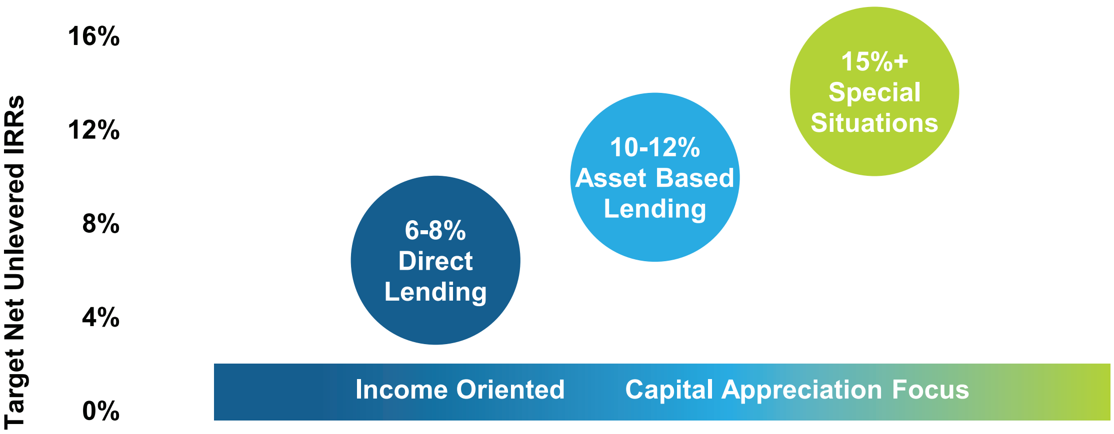

FIGURE 4

Targeted Net Unlevered IRRs by Strategy

Source: Meketa Investment Group, 2024.

Historical returns

Evaluating performance for the broad private credit asset class is challenging due to the diversity of strategies and a lack of robust performance data for many of the sub-strategies. The evolution of the asset class further complicates the proposition of using a single index as representative of the asset class as it exists today, as the composition of the private credit market is quite different than it was just 10-15 years ago, thus making it difficult to extrapolate past performance onto the current opportunity set.[17]

Yet, it is reasonable for investors to use the best benchmarks they can find to analyze performance for the asset class, even if it is admittedly less than perfect. Throughout this paper, we show two different proxies for private credit performance, the Cambridge Associates' US Private Credit Composite[19] and the Cliffwater Direct Lending Index ("CDLI").

[17] As shown in Figure 1, the mezzanine and distressed debt strategies represented the majority of the private credit universe from 2001 through the early 2010's. However, since 2014, direct lending has taken over as the single largest strategy, comprising around half of aggregate capital raised in each year of final close.

[18] Business Development Companies ("BDCs") are a type of investment company created by the Small Business Investment Incentive Act of 1980. The primary objective of BDCs is to provide small private companies with access to capital. They are closed-end investment vehicles with equity that can be publicly traded on a stock exchange. BDCs operate under strict guidelines, including the necessity to distribute at least 90% of taxable income to investors. Some investors believe that public BDCs can be a good alternative to a direct lending strategy. However, many BDCs are public companies (i.e., stocks) that will be marked to market daily and will trade with a high correlation to public equity markets. Because of this, BDC performance will likely be much more volatile than a private direct lending fund. Further, public BDCs can trade at either discounts or premiums to the fair market value of their portfolio of loans.

[19] Cambridge Associates' US Private Credit index is a composite of private credit funds that encompasses many underlying private credit strategies. However, the data in this benchmark is not nearly as robust as it typically is for Cambridge's other private markets composites (e.g., private equity). Returns are presented as IRR's, net of fees, on a vintage year and funds basis. The CDLI measures the unlevered, gross of fee performance of US middle market corporate loans, as represented by the underlying loan performance of business development companies.[18] While this index does not capture the breadth of the private credit universe, it is representative of the sector that currently comprises the largest share of the private credit market.

Figure 5 depicts how both private credit proxies generated returns in line with the asset class's public credit counterparts, bank loans and high yield corporate bonds. Since 2005, the CDLI had an annualized gross return of 9.4%, followed by US equity's 9.3%, Cambridge's US Private Credit's 9.1% net return, corporate high yield bonds' 6.1%, and bank loans' 4.5%.,[20] When looking at the trailing 10-year returns of the assets listed above, all had slightly lower returns and remained in the same order, with the exception of US equity whose returns increased, outperforming the other assets.

[20] Source: Cambridge Associates via IHS Markit, annualized quarterly Pooled IRR as of June 2023 (pulled in January 2024). Monthly returns sourced from Bloomberg as of June 2023 and converted to quarterly. Indices: Cambridge US Private Credit Composite, Cliffwater Direct Lending index, Credit Suisse Leveraged Loan, Bloomberg US Corporate High Yield Bond Index, Russell 3000. For the period Q1 2005 through Q2 2023. CDLI returns are gross of fees, all other returns are net of fees. 2005 was chosen because it is the first year that the CDLI has a complete year of data.

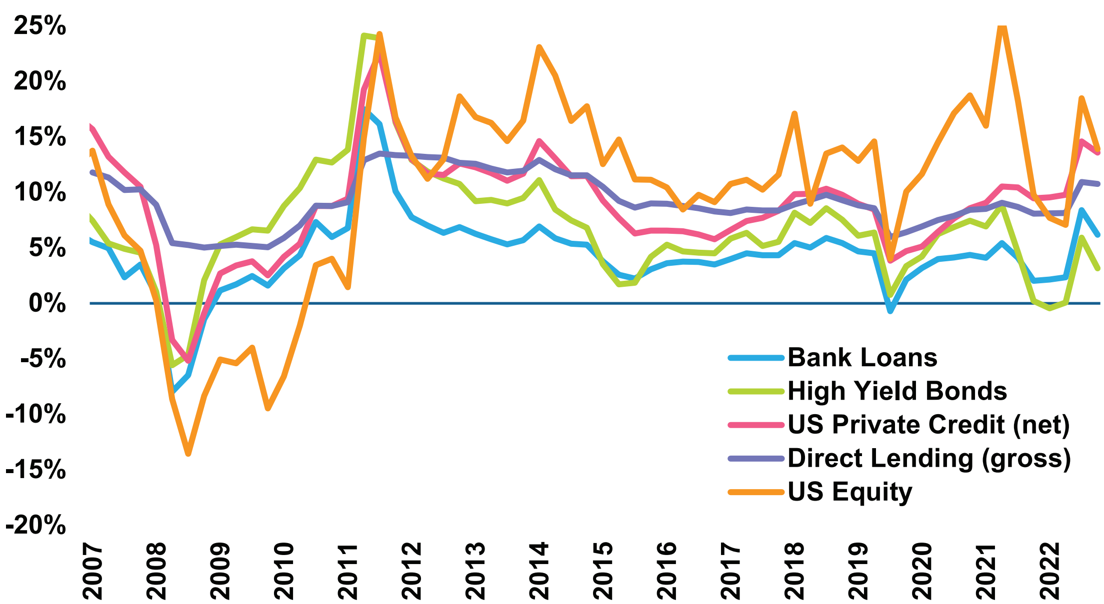

FIGURE 5

Rolling 3-Year Annualized Returns

Source: Cambridge Associates via IHS Markit, annualized quarterly Pooled IRR as of June 2023 (pulled in January 2024). Monthly returns sourced from Bloomberg as of June 2023 and converted to quarterly. Indices: Cambridge US Private Credit Composite, Cliffwater Direct Lending index, Credit Suisse Leveraged Loan, Bloomberg US Corporate High Yield Bond Index, Russell 3000. CDLI returns are gross of fees, all other returns are net of fees.

Historical volatility

Historical volatility has generally followed the same trends for both private credit and its public markets counterparts. Since 2005, US equity had the highest annualized standard deviation at 16.9%, followed by high yield bonds' 10.7%, bank loans' 9.3%, Cambridge's US private credit's 9.2%, and the CDLI's 3.5%.[21] However, the methodology used in the calculation of the CDLI may artificially smooth the volatility of returns, particularly during periods of market stress.[22] Additionally, Cambridge's US private credit volatility may also be smoothed and lagged when compared to public market credit indices due to the inherent nature of private markets valuations and reporting. Volatility for all of the credit indices have been lower than for US equities.

[21] Source: Cambridge Associates via IHS Markit, annualized quarterly Pooled IRR as of June 2023 (pulled in January 2024). Monthly returns sourced from Bloomberg as of June 2023 and converted to quarterly. Indices: Cambridge US Private Credit Composite, Cliffwater Direct Lending index, Credit Suisse Leveraged Loan, Bloomberg US Corporate High Yield Bond Index, Russell 3000. For the period Q1 2005 through Q2 2023.

[22] Cliffwater calculates performance based on the performance of the underlying loans in the BDCs as filed with the SEC. The loans are valued quarterly. Further, Cliffwater assumes that loans will converge to par over a 3-year horizon, regardless of the maturity date. During periods of market stress, such loans may take longer than three years to reach par. See Munday, et. al., "Performance of Private Credit Funds: A First Look," The Institute for Private Capital, May 7, 2018.

Note: For purposes of return comparison, throughout this document we linked quarterly IRRs of Cambridge's US Private Credit Composite as reported by Cambridge Associates. This is because time-weighted returns for these series were not available, and the quarterly IRRs used should not differ materially from time-weighted quarterly returns. Note that the trailing returns we present by linking the quarterly IRRs are different from the trailing IRRs, as the trailing IRRs are running the calculation over a longer period in which the weighting of cash flows has a more substantial impact.

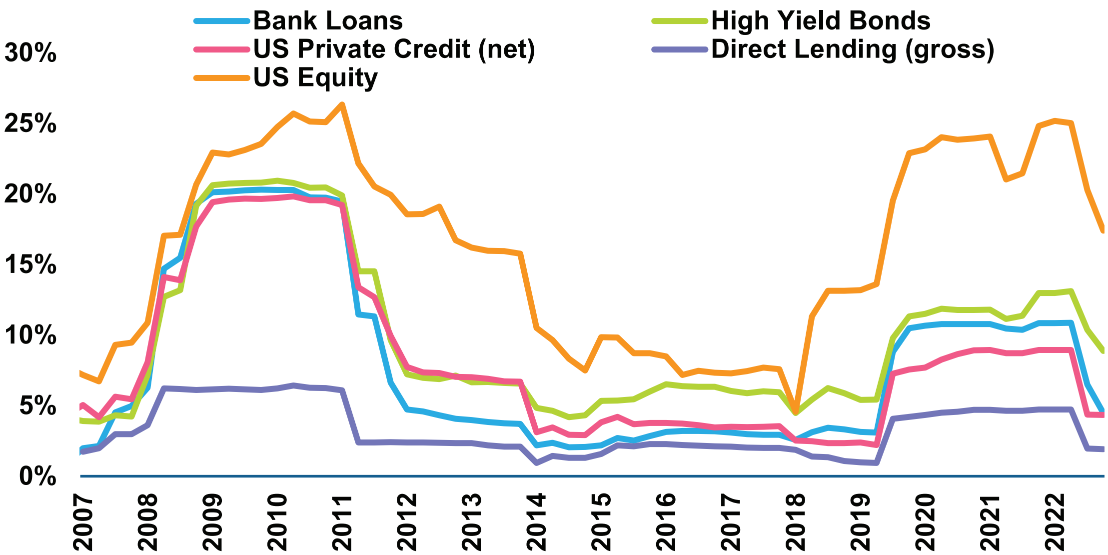

FIGURE 6

Rolling 3-Year Annualized Volatility

Source: Cambridge Associates via IHS Markit, annualized quarterly Pooled IRR as of June 2023 (pulled in January 2024). Monthly returns sourced from Bloomberg as of June 2023 and converted to quarterly. Indices: Cambridge US Private Credit Composite, Cliffwater Direct Lending index, Credit Suisse Leveraged Loan, Bloomberg US Corporate High Yield Bond Index, Russell 3000.

Diversification potential

Cambridge's US private credit composite and the CDLI have a high correlation both to each other as well as to their public markets' counterparts. High yield corporate bonds and bank loans each had correlations that have averaged above 0.73 with Cambridge's US private credit composite and the CDLI.[23] This indicates a generally high correlation and thus limited diversification benefits relative to their public market counterparts, though the stability of the correlation has varied over time. However, historical returns for the Cambridge US private credit index and CDLI largely encompass corporate focused strategies (e.g., direct lending, special situations) and as such do not fully capture the breadth of strategies that currently comprise the private credit universe.

[23] Source: Cambridge Associates via IHS Markit, annualized quarterly Pooled IRR as of June 2023 (pulled in January 2024). Monthly returns sourced from Bloomberg as of June 2023 and converted to quarterly. Indices: Cambridge US Private Credit Composite, Cliffwater Direct Lending index, Credit Suisse Leveraged Loan, Bloomberg US Corporate High Yield Bond Index. For the period Q1 2005 through Q2 2023.

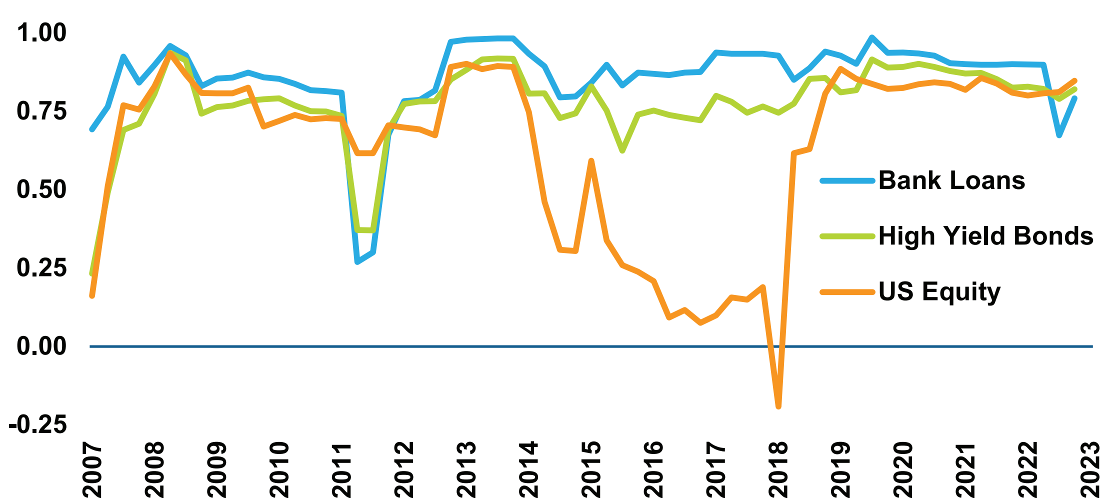

FIGURE 7

Rolling 3-Year Correlation to Direct Lending

Source: Monthly returns sourced from Bloomberg as of June 2023 and converted to quarterly. Indices: Cliffwater Direct Lending index, Credit Suisse Leveraged Loan, Bloomberg US Corporate High Yield Bond Index, Russell 3000.

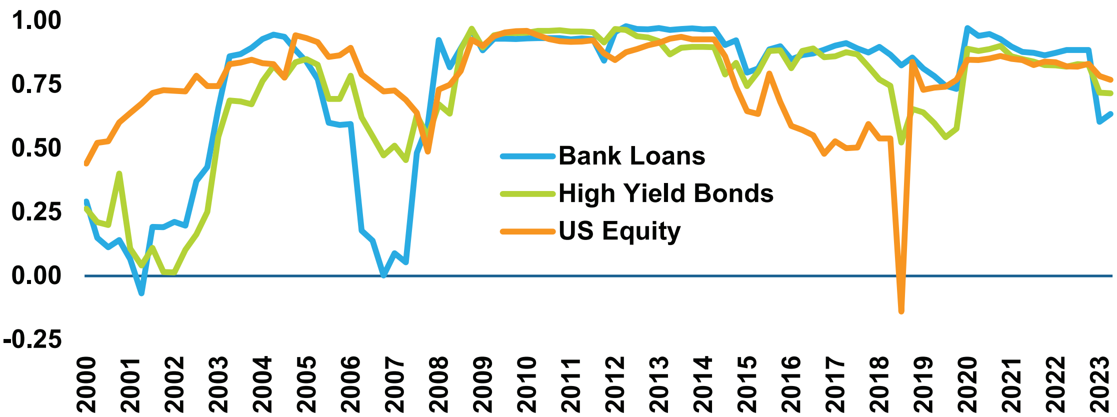

FIGURE 8
Rolling 3-Year Correlation to US Private Credit

Source: Cambridge Associates via IHS Markit, annualized quarterly Pooled IRR as of June 2023 (pulled in January 2024). Monthly returns sourced from Bloomberg as of June 2023 and converted to quarterly. Indices: Cambridge US Private Credit Composite, Credit Suisse Leveraged Loan, Bloomberg US Corporate High Yield Bond Index, Russell 3000.

When evaluating private credit's diversification benefits relative to traditional US equities, bonds, and private equity, we find that, again, both Cambridge's US private credit composite and the CDLI have very similar correlations. Since 2005, both private credit proxies had average correlations of 0.70 and higher with US equity, 0.79 and higher with US private equity, and no correlation with US investment grade bonds.[24] This implies that US private credit may offer diversification benefits from the interest rate-sensitive portion of the US bond market, though not substantial diversification from the US equity and private equity markets.

[24] Source: Cambridge Associates via IHS Markit, annualized quarterly Pooled IRR as of June 2023 (pulled in January 2024). Monthly returns sourced from Bloomberg as of June 2023 and converted to quarterly. Indices: Cambridge US Private Credit Composite, Cambridge US Private Equity Composite, Cliffwater Direct Lending index, Russell 3000, Bloomberg Aggregate Bond Index. For the period Q1 2005 through Q2 2023.

Downside protection

Private credit funds, for the most part, invest in current pay instruments that provide steady income for a portfolio. This not only may provide an aspect of downside protection, but it also potentially reduces overall portfolio volatility. Downside protection may come from other sources as well, such as structural protections, seniority in the capital structure, better control over loan documentation, and access to borrower performance metrics. Moreover, most private credit instruments are floating rate, which reduces the overall interest rate sensitivity of the asset class.

Private credit may help to provide investors downside protection during market downturns. As shown in Figure 9, private credit strategies have fared better than US equity during the major market downturns over the last twenty years.

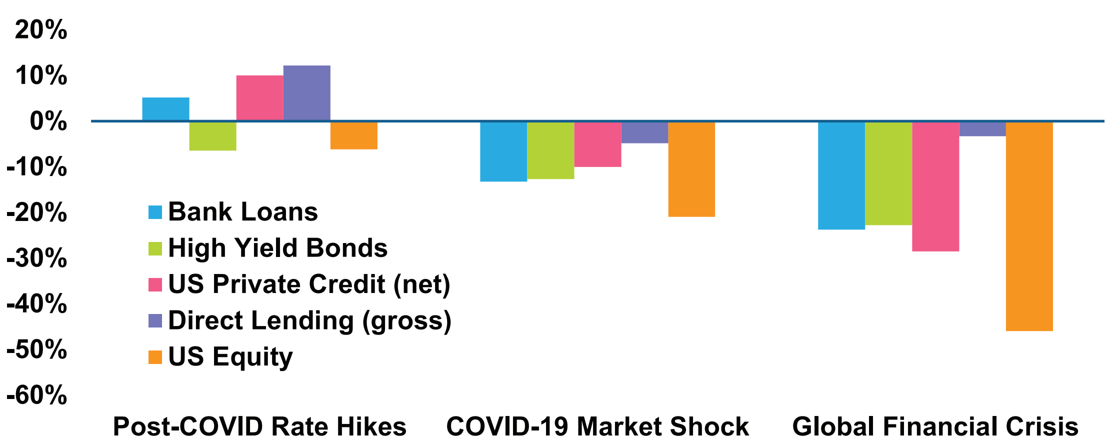

FIGURE 9
Returns During Historical Market Downturns

Source: Cambridge Associates via IHS Markit, annualized quarterly IRR as of June 2023 (pulled in January 2024). Monthly returns sourced from Bloomberg as of June 2023 and converted to quarterly. Indices: Cambridge US Private Credit Composite, Cliffwater Direct Lending index, Credit Suisse Leveraged Loan, Bloomberg US Corporate High Yield Bond Index, Russell 3000. Returns are cumulative for the time period over which the scenario occurred. Dates for the three events in order are: Oct 2007 – Mar 2009, Feb 2020 - Mar 2020, Jan 2022 – June 2023.

Manager alpha potential

Interquartile spreads can be interpreted as the potential value associated with selecting superior funds/managers. The range of potential return outcomes within the private credit asset class is illustrated by the interquartile spreads shown in Figure 10. Private credit's manager return dispersion is larger than that for bank loans and high yield bonds, though it is considerably less than private equity. This may imply that funds in the private credit asset class have more potential to add value than their public credit counterparts, but less potential than some other private markets asset classes such as private equity.

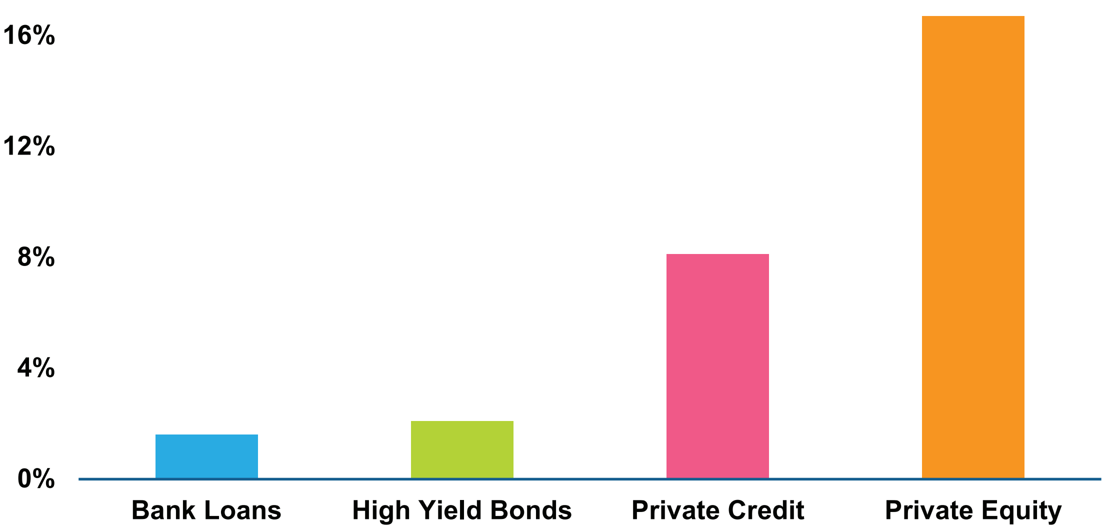

FIGURE 10

Interquartile Spreads (Trailing 10 Years)

Source: Cambridge Associates via IHS Markit, IRR quartiles by vintage year, and eVestment data pulled in April 2024. Private asset funds raised Vintage Year 2012 to 2021. High yield and bank loan data for the trailing 10 years as of December 31, 2022. Indices: Cambridge Private Credit Composite, Cambridge Private Equity Composite, eVestment High Yield Universe, eVestment Bank Loans Universe. Average fund count is 33 for private credit, 107 for private equity, 84 for bank loans, 143 for high yield. For more information on the bank loans and high yield alpha calculation, see Meketa's Manager Alpha Whitepaper.

The various strategies within private credit also have a range of potential value add. For example, an income-focused strategy like direct lending generates its returns primarily through the repayment of principal plus accrued interest minus any losses, which generally results in the smallest potential for funds/managers to add value. At the other end, special situations funds typically have a higher return spread due to the increased overall riskiness of the strategy and higher potential for equity-like positions.

Implementation considerations

Fund structure and the J-curve

Private credit fund structures are generally closed-end partnerships with an investment period of two- to four-years and a final term of five- to eight-years. The final term may be subject to optional extensions, with one typically at the General Partner's ("GP's") discretion and one subject to approval by the advisory board. In practice, private credit fund terms are shorter in comparison to private equity and other private market funds. The shorter term reflects the shorter duration of most private credit assets, which may be refinanced, prepaid, or amortized. Depending on the sub-strategy, the J-curve associated with private credit is also shallower in comparison to private equity due to the earlier distribution of income or return of capital. These distributions are often recycled during the investment period, which affords an investor the opportunity to increase their multiple of invested capital ("MOIC").

For strategies with a high income component, open-end or evergreen fund structures are becoming more common. The shorter duration of these private credit assets and quicker pace of deployment mean that closed-end fund managers would need to come back to market more frequently to raise capital. Evergreen structures may offer some key benefits, particularly for investors that do not anticipate making multiple commitments of size in any given year. One primary advantage is the ability to buy into a diversified portfolio of assets, potentially mitigating the J-curve and blind pool risk associated with private markets assets. A comparison of open- and closed-end structures is provided below in Figure 11.

	Open-end	Closed-end
Relative Strengths	→ Remain invested which reduces cash drag with ramp-up and wind-down. Permits more efficient recycling. → More efficient use of Board time as there is no need to come back to the Board for re-ups. → Commitments can be made any time, potentially subject to queue. → No blind pool risk.	→ Higher returns possible via liquidity premium and wider strategy selection. → Fee structure generally better aligns LP/GP economics. → Carry paid on realization as opposed to more recent valuation. → Co-investment opportunities.
Considerations	→ Incentive fees crystallized according to calendar year as opposed to realization. → LP subscribes into a fund based on Net Asset Value that often contains assets that are difficult to price. → Drawdown of commitment can be delayed. → Liquidation typically ties to the life of the underlying assets which can be uncertain and can have a long tail. → Not appropriate for strategies that are opportunistic or dependent on illiquidity.	→ Blind pool risk (could be mitigated by pre-seeded assets or later closing). → Managers only periodically in the market. → Requires more Board time for re-ups.

FIGURE 11
Comparison of Private Credit Open-end and Close-end Structures

Source: Meketa Investment Group, 2024.

Illiquidity

Illiquidity is an important consideration for investors within private markets. However, illiquidity risk may be somewhat lessened for investors in private credit funds. While achieving full liquidity for an investor's position in a fund would likely require a sale in the secondary market, the steady income component should provide a quicker return of capital than is common for other illiquid strategies.

Vintage year diversification

Vintage year diversification is just as important for private credit portfolios as for other asset classes. Different vintage years may experience varying economic conditions, market cycles, or performance trends. There is the potential for poor vintage year timing when structuring a private credit program, just as in other areas of private markets. Missing out on a particularly good year, or overcommitting to a particularly bad one, will harm performance.

By diversifying across vintage years, investors can reduce the impact of poor performance in a particular year or economic environment. This helps to mitigate risk and minimize the potential negative effects of a single vintage year's underperformance. Therefore, vintage year diversification is important for a well-rounded private credit allocation. Using pacing plans, following them, and regularly updating them, is considered a "best practice" for maintaining vintage year diversification.

Fees

The fees and additional expenses on private credit funds are higher than public market options. Fee structures in private credit vary widely depending on fund structure and sub-strategy. Most private credit funds are structured as closed-end drawdown vehicles with a management fee and a performance-based fee (i.e., "carry") that kicks in above a pre-specified preferred return (i.e., "hurdle"), as with many private market investment vehicles. The emergence of open-end funds has led to a wider variety of fee structures including some that mirror core open-end funds in private real estate and infrastructure with a flat management fee paid on net asset value. The mean management fees shown in Figure 12 below are consistent with what we tend to see in the market, namely, income-oriented strategies such as direct lending generally charge lower fees than the capital appreciation focused strategies typically found in special situations. Similarly, carry and hurdle rates also tend be lower for income oriented strategies and higher for capital appreciation strategies.

Private Credit Sub-Strategy	Management Fee (%)
Direct Lending	1.56%
Mezzanine	1.76%
Special Situations	1.76%
Distressed	1.85%

FIGURE 12

Mean Private Credit Management Fee of the Past 10 Vintage Years

Source: Preqin, 2023 Private Capital Fund Terms Advisor, October 2023. Figures are the average of the mean management fee for the past 10 vintage years.

Across strategies funds, the management fee and carry tend to be lower for direct lending and asset based lending, and higher for special situations strategies. Several primary drivers for the variance between fees include:

- *Open vs closed-end structure:* Open-end funds generally lack a natural point for performance fee crystallization such as the harvest period in a closed-end structure. To account for this, some open-ended funds do not have a performance fee. A trade-off is a potential reduction in the alignment of incentives as a calendar year fixed fee is charged on net asset value.
- *Complexity and competition:* Strategy complexity, operational costs, and the number of funds competing within a strategy are primary reasons for differing fee structures. For example, direct lending is at the lower end, while special situations or niche assets are at the higher end.
- *Leverage:* Use of external fund-level leverage typically increases expected returns. To account for this, GPs often employ a higher hurdle rate.

Beyond headline fees, limited partners should consider the following in any review of fee structures: i) are management fees paid on *committed* or *invested* capital; ii) are fees charged on net invested equity or gross assets inclusive of leverage; iii) are fees paid to the GP as part of executing the strategy used to reduce (i.e., "offset") fees charged to limited partners; and iv) what is the level of affiliated fees associated with implementation of the strategy? Finally, investors making large commitments often receive lower fee rates at one or more break levels.

Summary

Private credit is a form of financing originated by non-bank lenders under privately negotiated terms. Borrowers might opt for private credit over public markets for several reasons, such as the need for tailored financing solutions or the lack of access to public capital due to size or credit history. The private credit market has evolved considerably, particularly since the GFC. The growth of the asset class has transitioned to more secular demand drivers as investors have come to appreciate its portfolio benefits and the need for alternative sources of financing has expanded.

Meketa has identified four main strategies within private credit: direct lending, asset-based lending, special situations, and diversifying. Each of these strategies has unique risk-return profiles and characteristics. These strategies provide investors with the flexibility to construct portfolios that offer a variety of collateral types, deal structures, and sources of return.

Private credit offers the opportunity to access potentially higher yield and return than those available in public market fixed income assets. Benefits for institutional portfolios extend beyond returns to include the potential for volatility dampening, downside protection, and alpha via the selection of skilled managers. Return behavior will tend to resemble that of other growth and credit-oriented asset classes, as private credit exhibits relatively high correlations with public credit and equities.

As with any private market asset class, investors should be prepared to deal with diligence requirements, illiquidity, and higher fees. Investors should consider the breadth of the asset class as they seek to build a strategic allocation consistent with their objectives and constraints.

Appendix 1 | Cambridge Associates private credit strategies' descriptions

Cambridge Associates uses different categories for classifying private credit strategies than Meketa. Below are the strategies and descriptions used in the Cambridge Private Credit composite.

Strategy	Description
Credit Opportunities	Funds that invest in a broad spectrum of credit and debt related investments across multiple geographies. Investments include but not limited to traditional high yield bonds and bank loans, corporate distressed debt, nonperforming loans (NPLs), real estate, structured finance, and dislocated industries (i.e. aviation, energy, shipping, royalties).
Senior Debt	Funds that provide senior secured loans for companies seeking to finance acquisitions, add-ons, restructurings and/ or bridge loans. Senior loans offer a level of downside protection through priority of claim on assets in the event of bankruptcy in addition to embedded covenants. The loans typically have floating rate coupons priced off LIBOR and benefit from LIBOR floors and/ or upfront origination fees. These investments may offer a lead role in refinancing's with the ability to influence.
Subordinated Capital	Funds that invest in securities that lie between equity and secured debt. These investments are most often made to finance buyout but can also be used in place of growth equity. Along with the typical interest payment associated with debt, mezzanine capital will often include an equity stake in the form of warrants attached to the debt obligation or a debt conversion feature identical to that of a convertible bond.

FIGURE 13
Cambridge Associates Private Credit Strategies

Source: Meketa Investment Group, 2024.

Appendix 2 | Default history

The primary risks associated with private credit can vary by sub-strategy, but at the most fundamental level, failure to pay or capital impairment (i.e., default) is the primary risk across all private credit assets.

Loss avoidance, or avoiding default by the borrower, is of significant importance, particularly to direct lending strategies as they do not offer much (if any) upside potential. Loss avoidance is core to manager and fund selection and is tied to sourcing, underwriting, deal structuring (including structuring covenants), monitoring, as well as prudent loan level diversification.

Default rate data for private credit is scare and has a very short available history. As figure 14 illustrates, the level default rates for private credit tend to move in tandem with those for high yield and bank loans, at least since 2020.

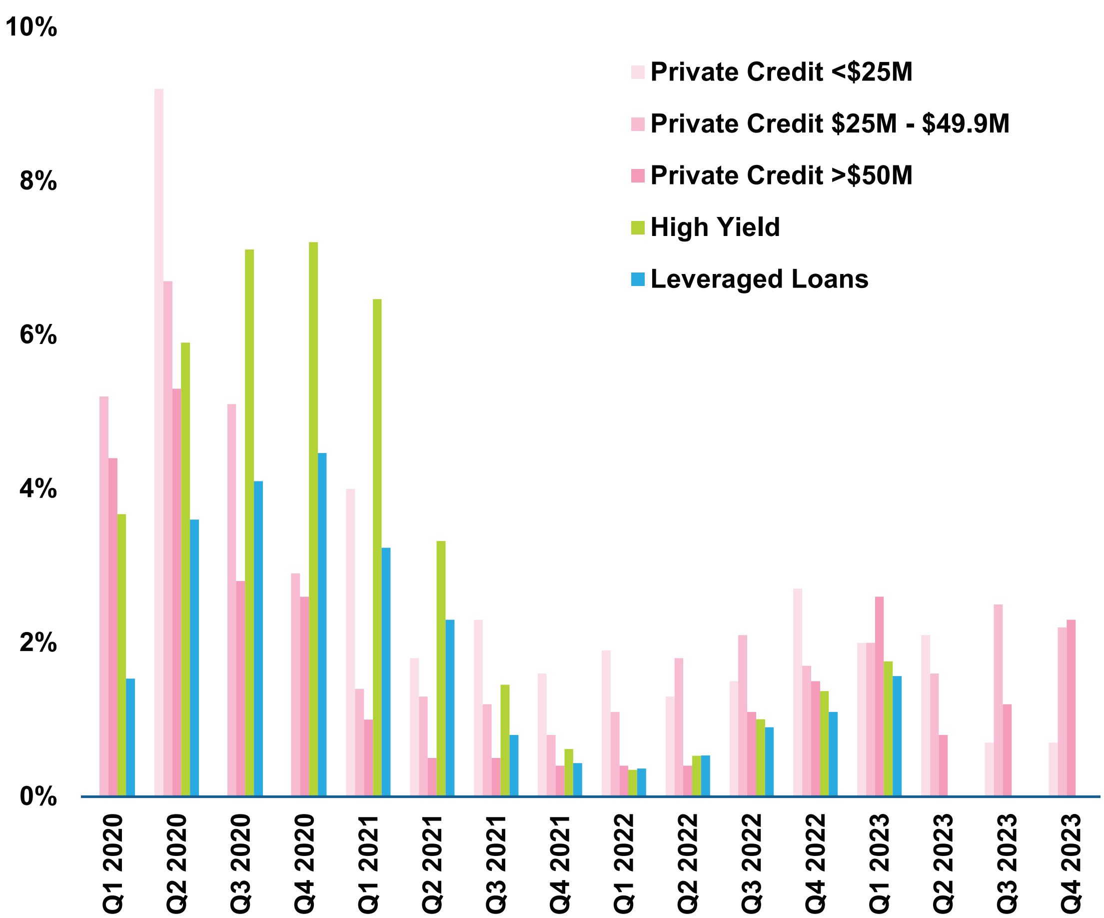

FIGURE 14

Recent Historical Default Rates for Public and Private Credit

Source: High yield and bank loan default rate estimates from JP Morgan as of April 2023. Monthly default rate estimates converted to quarterly by taking an average of the quarter. Indices used: ICE BofA US High Yield Index and Credit Suisse Leveraged Loan Index. Quarterly private credit default rate data by EBITDA bucket from Proskauer as of January 2024. EBITDA buckets for Q2 2020 and 2021-2023 are less than $25M, $25 to $49.9M and greater than or equal to $50mm. Prior to 2021, there were only two buckets of EBITDA's $25M to $49.9M and greater than or equal to $50M, with the exception of Q2 2020.

As Figure 15 illustrates, the default rates of 2020 were well below those experienced by high yield bonds and bank loans during the popping of the dot-com bubble and the GFC. Extrapolating from the short interlude of Figure 13, it may be reasonable to expect that default rates for private credit would likewise have experienced much higher levels during those periods (i.e., that they offer a similar level of credit risk as is present for high yield bonds and bank loans).

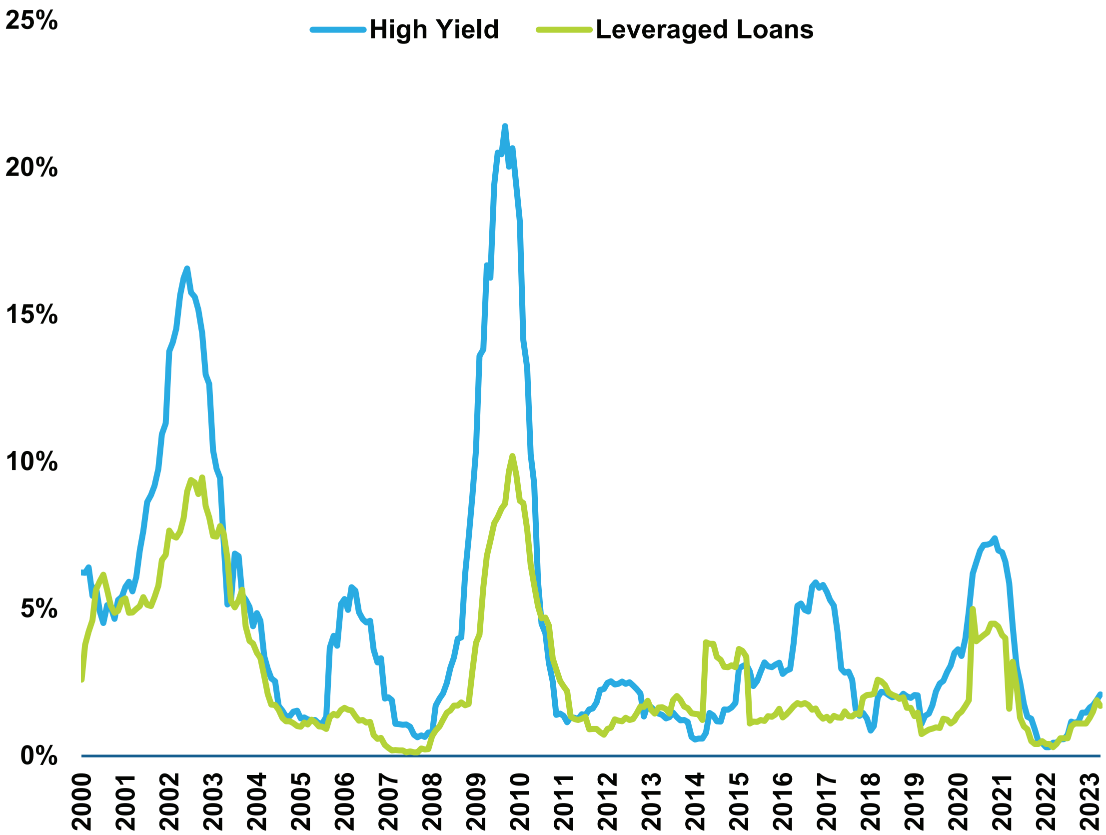

FIGURE 15

Historical Default Rates for Public Credit

Source: Monthly default estimates from JP Morgan as of April 2023. Indices used: ICE BofA US High Yield Index and Credit Suisse Leveraged Loan Index.

Disclaimers

This document is for general information and educational purposes only, and must not be considered investment advice or a recommendation that the reader is to engage in, or refrain from taking, a particular investment-related course of action. Any such advice or recommendation must be tailored to your situation and objectives. You should consult all available information, investment, legal, tax and accounting professionals, before making or executing any investment strategy. You must exercise your own independent judgment when making any investment decision.

All information contained in this document is provided "as is," without any representations or warranties of any kind. We disclaim all express and implied warranties including those with respect to accuracy, completeness, timeliness, or fitness for a particular purpose. We assume no responsibility for any losses, whether direct, indirect, special or consequential, which arise out of the use of this presentation.

All investments involve risk. There can be no guarantee that the strategies, tactics, and methods discussed in this document will be successful.

Data contained in this document may be obtained from a variety of sources and may be subject to change. We disclaim any and all liability for such data, including without limitation, any express or implied representations or warranties for information or errors contained in, or omissions from, the information. We shall not be liable for any loss or liability suffered by you resulting from the provision to you of such data or your use or reliance in any way thereon.

Nothing in this document should be interpreted to state or imply that past results are an indication of future performance. Investing involves substantial risk. It is highly unlikely that the past will repeat itself. Selecting an advisor, fund, or strategy based solely on past returns is a poor investment strategy. Past performance does not guarantee future results.