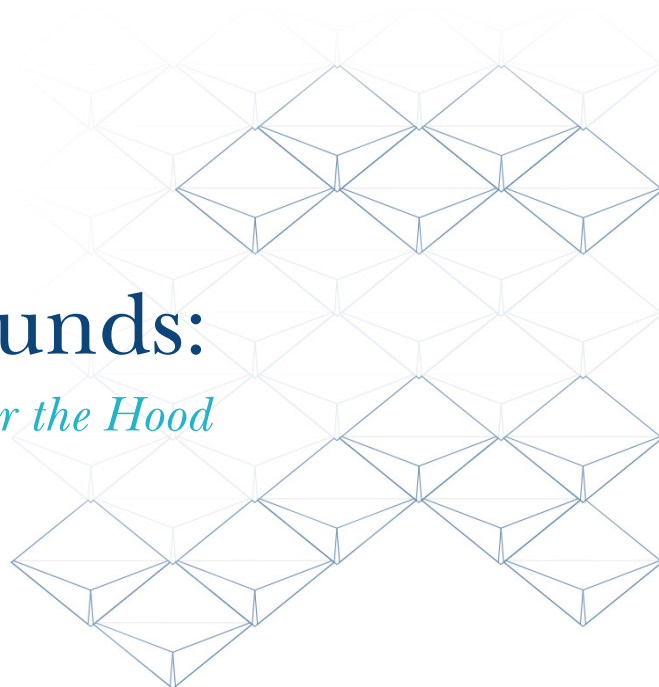


Hidden Leverage in Private Credit Funds:

How to Assess What's Hiding Under the Hood



Executive Summary

Many investors may not realize that the use of leverage among private credit funds varies widely. Some funds are completely unlevered, while others may employ meaningful leverage to achieve their target returns. What also varies is the type of leverage a fund may use. Standard or explicit leverage is easy to understand and detect, since it's visible on the fund's balance sheet.

Hidden leverage is less known to many private credit investors. This type of leverage is often embedded in the securities the fund invests in. It is opaque and can take multiple forms making it difficult to detect and quantify.

This brief presents why it's critical to assess the use of leverage when evaluating the risk-return profile of any private credit fund. Plus, it provides specific ways to identify and quantify hidden leverage under the hood of any private credit fund.

The bottom line: We want to help investors make informed decisions that align with their expectations for any private credit investment, and for their overall portfolio.

What's Inside

Why Private Credit
Funds Employ Leverage **2**

The Benefit and
Risk of Leverage **3**

Two Types of
Hidden Leverage **5**

The Bottom Line:
Understand the Return
Sources of Your Private
Credit Investments **6**

About Alternative Fund Advisors

Alternative Fund Advisors provides financial advisors and family offices with efficient and convenient access to private investments using interval funds.

Why Private Credit Funds Employ Leverage

Why would some private credit funds even use leverage, given the attractive yields of their underlying investments? The answer is that a shift in market dynamics over the past 10 years has increased the incentive for private credit funds to use leverage.

As far back as 2013, private middle market direct loans (MMDLs) enjoyed a healthy yield advantage of more than 6% over their tradeable counterparts, the broadly syndicated bank loans. However, the rapid inflow of capital to the private credit markets over the past 10 years has resulted in a significant compression of this once highly attractive illiquidity premium (see Exhibit 1).

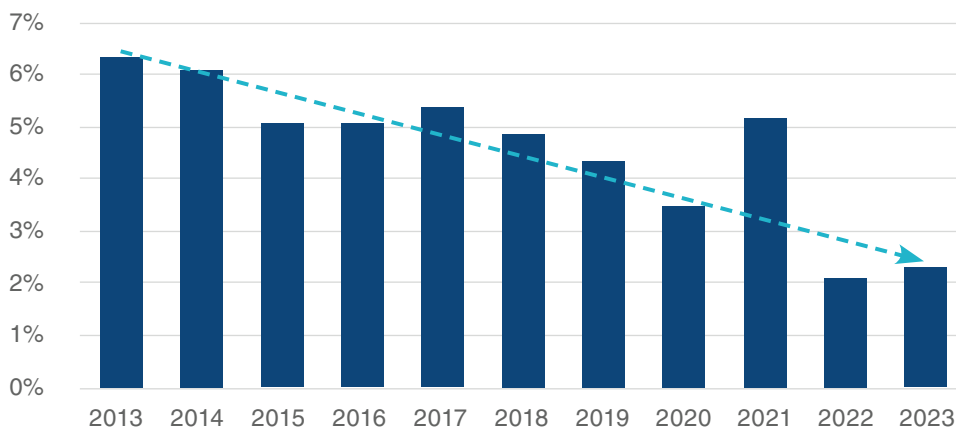
We believe that this shrinking illiquidity premium is putting middle market direct lending funds under pressure to utilize leverage in order to maintain their yield premium.

Anecdotally, the segments of the private credit market where unleveraged yields have compressed the most are those with the strongest incentive to use leverage. On the flip side, in less competitive segments funds may be able to maintain an attractive yield premium without having to resort to leverage.

The historically attractive illiquidity premium associated with private direct middle market loans relative to tradeable loans is shrinking.

EXHIBIT 1

Yield Differential of Private Middle Market Direct Loans vs. Tradeable Leveraged Loans (2013–2023)



Source: AFA analysis. S&P Morningstar Leveraged Loan Index, Cliffwater Direct Lending Index. 2013–June 2023.

The Benefit and Risk of Leverage

The business of banking is all about making a profit on the spread between borrowing funds at a low cost and making loans at a higher cost. This fundamental principle carries through to the use of leverage by private credit funds, since leverage is accretive to overall return when the yield on the assets is higher than the cost of the debt.

Leverage—whether explicit on the balance sheet or hidden—cuts both ways. It amplifies both positive and negative returns. We explore this risk-return tradeoff using a hypothetical private credit fund based upon historical data from the 10 largest non-publicly-traded BDCs.¹

We first consider how the hypothetical private credit fund would perform at various levels of leverage *assuming no losses*.² As shown

in Exhibit 2, with no leverage the fund would yield 8.0%. If the fund were to apply two turns of leverage—i.e., \$200 of debt for \$100 in net asset value—the yield would increase to 14.6%.³ However, this meaningful pick-up in return is predicated on a “benign environment” in which there are no credit losses.

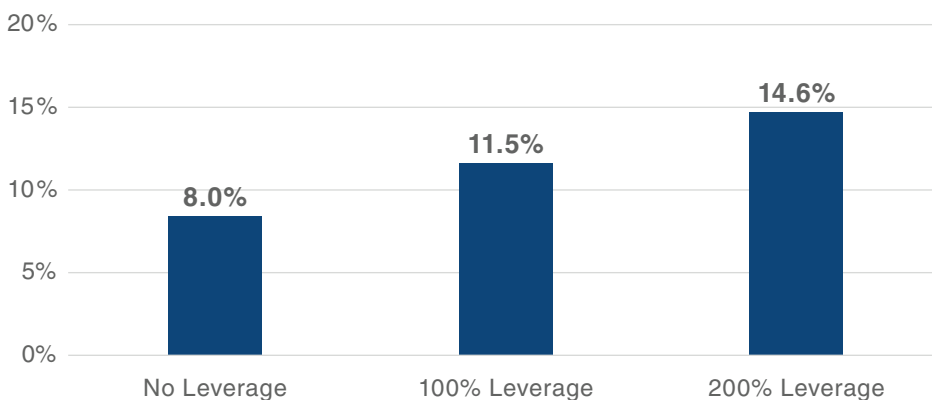
Now let’s explore what happens in a recessionary environment with mounting losses and portfolio markdowns. Exhibit 3 on the next page shows such a scenario.

We assume a gross return of -8% for the unlevered fund, which is based on the historical experience of the Cliffwater Direct Lending Index in the 2008/2009 financial crisis.⁴ With two turns of leverage, the fund would have experienced a -30% gross return.

While leverage has the potential to enhance returns in benign environments, it amplifies drawdowns when returns turn negative.

EXHIBIT 2

Expected Return at Different Leverage Levels Assuming No Losses



Source: SEC.gov and AFA. Hypothetical portfolio is based on the average yield, debt cost, and fees and expenses of the top 10 largest non-traded BDCs disclosed in the most recent SEC filing as of September 30, 2023.

A 2008/2009 scenario is extreme, but there are factors that suggest that credit losses may be higher than in the past even in milder recessions. The private credit market has grown and matured markedly since that severe recession, and we now observe fewer distinctions between the public and private middle market direct loans.

Over the last five to 10 years, this increased level of competition has led both public and private lenders to loosen borrower covenants, which may accentuate loss levels in the next downturn.

In practice, credit losses fall between the two extremes of zero credit losses and losses in a severe recession. As long as losses are modest, leverage enhances returns. However, our example highlights how significant drawdowns of a highly levered fund may be in adverse credit environments.

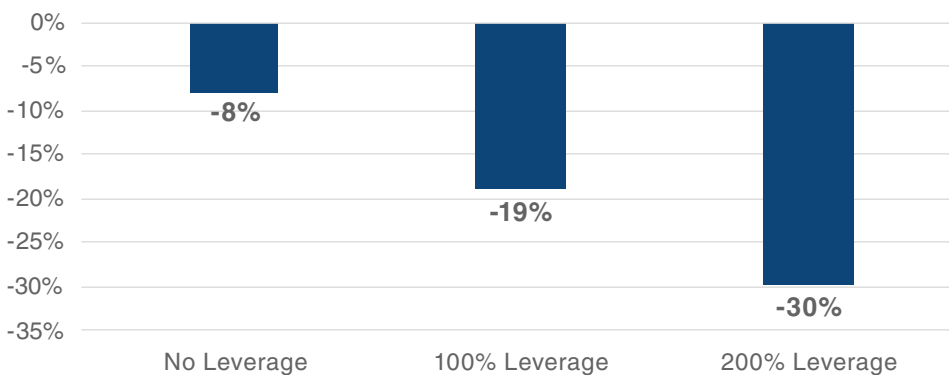
The Data for Our Model

The most recent SEC filings as of 9/30/2023 from the 10 largest non-publicly-traded BDCs provided us with these inputs for our model:

- Average asset yield
- Cost of debt
- Operational expenses
- Management fees
- Incentive fees

EXHIBIT 3

Expected Return at Different Leverage Levels Assuming Recession



Source: SEC.gov and AFA. Assumptions: AFA created returns utilizing 2008/2009 drawdown in the Cliffwater Direct Lending Index and adjusting them for leverage and yield.

¹ The hypothetical funds were created by AFA solely for information and education purposes. The hypothetical funds and the hypothetical returns presented are included only for illustrative and education purposes and do not represent any specific fund.

² For simplicity, we will refer to the “hypothetical private credit fund” as “the fund” in the remainder of the brief.

³ We use the term “one turn of leverage” or “100% leverage” for a 1:1 ratio of debt to net assets. Note that BDCs are allowed up to 200% leverage.

⁴ Assumptions: AFA created returns utilizing 2008/2009 drawdown in the Cliffwater Direct Lending Index and adjusting them for leverage and yield.

Two Types of Hidden Leverage in Private Credit Funds

Standard or explicit leverage is an easily understood concept. A fund borrows at a relatively low rate and reinvests the borrowed amount in a higher-yielding loan. It's easy to identify and quantify standard leverage by reviewing the fund's balance sheet to determine the amount of borrowing relative to its net assets.

What's less obvious is leverage that isn't explicitly found on the balance sheet. This hidden leverage results from a fund investing in loans, securities, or other structures that are themselves levered. Hidden leverage is more difficult to detect and quantify, so allocators to private credit need to understand what's hiding under the hood, both before making an investment and in subsequent monitoring.

Here are two types of hidden leverage to look for during the due diligence process of a private credit fund:

1. Underlying Fund Leverage

What it is: A fund may invest in other funds or vehicles that themselves have embedded leverage, such as LPs, BDCs, or SPVs. By statute, BDCs may have up to 200% leverage, so it's important to pay particularly close attention to investments in BDCs.

How to detect it: Review a fund's statement of investments for any LPs, BDCs, and SPVs. If you identify any of these kinds of vehicles, dig deeper by asking

the fund manager to provide additional information about any leverage associated with these underlying investments. Things to look for include the magnitude of leverage, terms of the leverage, and the cost of leverage.

2. Financial Engineering

What it is: We use the term "financial engineering" for securitized structures such as private credit CLOs. In such instances, the private credit fund or its partners may transfer loans off balance sheet and into a securitization trust. This loan trust is then sliced up into different tranches, typically with outside investors buying the higher-rated tranches and the fund retaining the lower-rated tranches.

How to detect it: The way to identify and quantify leverage in securitized structures is by asking the private credit manager for details. Senior bonds are the least levered, while the equity tranche is the most levered, the riskiest, and the one most often held by private credit funds.

The key point is that private credit funds can obtain leverage in ways besides direct borrowing. The only way to fully evaluate a fund's leverage is to look beyond the balance sheet, review its statement of investments, and obtain additional transparency from the fund's manager.

Hidden leverage often results from a fund investing in loans, securities, or other structures that are themselves levered. Investors need to look beyond the balance sheet to find it.

Two Types of Hidden Leverage

- Underlying Fund Leverage**
 This occurs when a fund invests in other funds or vehicles that have embedded leverage.
- Financial Engineering**
 This occurs when a fund deploys securitized structures.

The Bottom Line: Understand the Return Sources of Your Private Credit Investments

Investors have different appetites for risk, and different risk-return profiles, so different degrees of leverage may be appropriate for different circumstances. In making this decision, we encourage private credit investors to consider:

- **How much effective leverage does the fund employ?** This entails taking into account both explicit and potential hidden leverage.
- **To what extent are the fund's current yield and past returns a function of leverage?** Comparing returns without accounting for leverage ignores the downside risk masked by the very low defaults over the last decade.
- **What is the tradeoff between the potential benefit of enhanced returns and the potential risk?** Weighing this tradeoff will help investors better align their expectations in different economic environments.

While leverage can be accretive when the wind is at your back and seas are calm, investors should always be mindful of aligning expectations for fund returns should markets become rocky.

While leverage can be accretive when the wind is at your back and seas are calm, investors should always be mindful of aligning expectations for fund returns should markets become rocky.

Disclosures

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Definitions

Cliffwater Direct Lending Index: The Cliffwater Direct Lending Index, or CDLI, is an asset-weighted index of 13,000+ directly originated middle market loans totaling \$284 billion as of June 30, 2023.

S&P Morningstar Leveraged Loan Index: The Morningstar LSTA US Leveraged Loan Index is a market value-weighted index designed to measure the performance of the US leveraged loan market.



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