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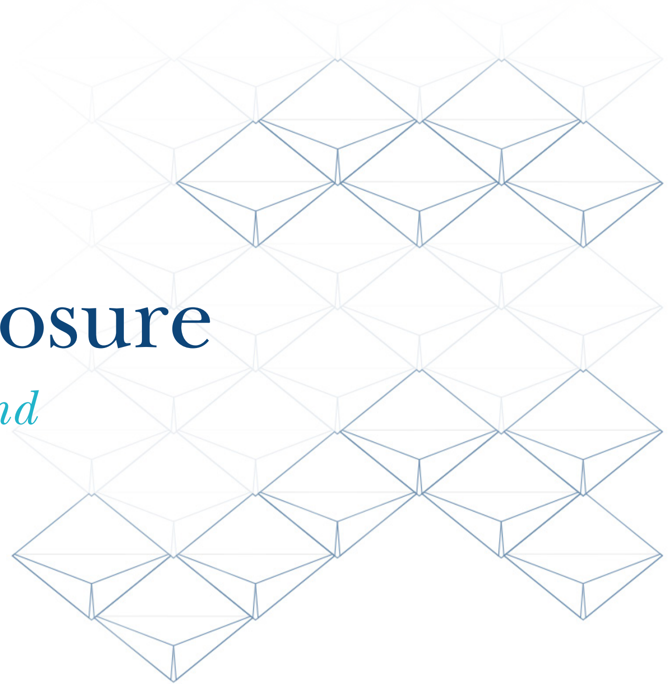

Optimize Your Private Credit Exposure

A Framework for Diversifying Beyond Corporate Direct Lending

Executive Summary

Private credit is often perceived as synonymous with its largest segment: corporate direct lending. Yet as many as 30 additional private credit segments exist, each with distinct risk-return characteristics. This abundance of choice provides investors with an opportunity to diversify beyond corporate direct lending when building a private credit portfolio.

While investors seeking to diversify their private credit exposure may be tempted to simply buy a little bit of every segment, we believe the essence of diversification is to spread bets intentionally across investments with markedly different risk and return characteristics.

In this paper we introduce a two-by-two framework for classifying private credit segments. The first dimension is loan size, which is related to potential returns. The second dimension is the underwriting method—cash flow based versus asset based—which correlates to risk, especially during periods of economic and credit stress.

We believe this framework can assist investors to classify potential private credit investment opportunities, align their existing private credit exposure to their desired risk-return preferences, and make intentional choices about how best to diversify their exposure to the asset class.

About Alternative Fund Advisors

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

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Why Private Credit in the First Place?

Private credit is a $2.1 trillion asset class that has been growing rapidly and has become a full-fledged "bucket" in most institutional portfolios.[1] More recently, the emergence of registered funds such as private business development companies (BDCs) and interval funds has democratized the asset class, making private credit more accessible to financial advisors and their clients.

The explosion of private credit has been driven by the retrenchment of lending by traditional banks in a tighter regulatory climate and the emergence of a new breed of alternative lenders. Private credit is compelling to investors because it offers a return premium over public markets, relatively low volatility compared to daily traded instruments, and diversification to a traditional fixed income portfolio.

Far from being a fad, its return premium is supported by intuitive risk premia such as the liquidity premium and the sourcing premium.[2]

Fueled by bank retrenchment, private credit has been growing rapidly thanks to its attractive risk-return characteristics.

Private Credit Market Segments: An Embarrassment of Riches

The largest and best-known segment of the private credit market is corporate direct lending. Its size makes it possible for investors to make substantial allocations, and it is often the first foray into the asset class for investors new to private credit. Indeed, much of the recent media coverage uses "private credit" as a synonym for corporate direct lending.

However, there are many other types of private credit. Various market observers of private credit have identified as many as 10 to 30 market segments, ranging from real estate debt and distressed lending to more niche segments such as litigation finance and specialty finance.[3] Each of these segments has its own risk-return characteristics and sensitivity to economic and credit conditions.

[1] IMF: www.imf.org/en/Blogs/Articles/2024/04/08/fast-growing-USD2-trillion-private-credit-market-warrants-closer-watch

[2] The sourcing premium refers to the fact that investors in private loans must originate them on their own rather than purchasing a fixed income security on the open market.

[3] Stephen Nesbitt's 2023 book *Private Debt: Yield, Safety and the Emergence of Alternative Lending* enumerates 11 segments; Briarcliffe's *Field Guide to Private Credit* (May 2023) lists 26 segments; and Aksia distinguishes between 35 segments in its June 2023 paper *Private Credit: More than Just Direct Lending*.

A Two-by-Two Framework for Optimizing a Private Credit Portfolio

Private credit investment opportunities extend beyond corporate direct lending. With so many segments to choose from, we believe the two-by-two framework shown in Exhibit 1 can help investors evaluate their options and construct an optimized portfolio.

We classify segments along two dimensions:

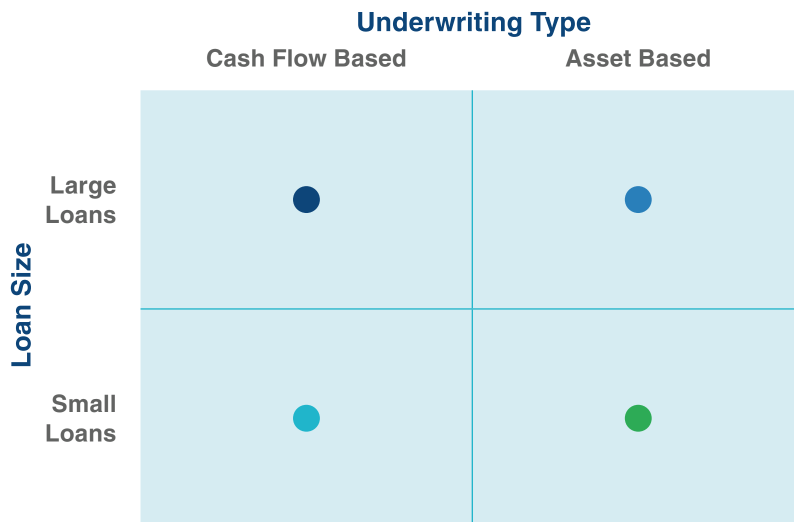
- **Loan Size:** Small versus Large
- **Underwriting Type:** Cash Flow Based versus Asset Based

We have chosen these two dimensions because they provide investors with a good first-cut indicator of the distinct risk-return characteristics they can expect when investing in a given private credit segment.[4]

Grouping private credit strategies by loan size and underwriting type provides a useful first-cut framework for analyzing risk-return characteristics.

EXHIBIT 1

Private Credit Two-By-Two Framework



[4] As with any two-by-two framework, this is a simplified construct. A complete assessment of the expected risk and return of a given PC fund investment needs to consider a number of additional dimensions such as the seniority of the underlying loans, the seniority of the tranche in the case of structured debt, and the leverage applied to the portfolio, among others.

How Loan Size Can Influence Potential Returns

Loan size, the first dimension in our two-by-two framework, has a significant impact on the economics of private credit loans. Intuition and specific empirical evidence both support the thesis that smaller loans exhibit a premium compared to larger ones.[5]

The market for lending to smaller borrowers is less heavily competed than the market for large loans.

Intuition for the Small Loan Premium

The underlying rationale for the small loan premium relates to the power dynamics between the lender and the borrower. This manifests itself in three ways:

1. **Supply-Side Competition for Large Loans.**
In 2023, almost 50 private credit managers each raised funds in excess of $10 billion.[6] To deploy this vast amount of capital, large lenders compete vigorously to make large loans. Further, large private loans face competition from syndicated bank loans. This puts disproportionate pressure on rates for large loans compared to smaller ones.

2. **Larger Borrowers Have More Negotiating Power.**
Large borrowers can obtain multiple bids and negotiate better rates, while smaller borrowers generally have fewer options and less negotiating power. Hence, smaller borrowers tend to face more onerous rates and terms.

3. **Large Private Borrowers Are Often PE-Sponsored.**
A small difference in rate can have a dramatic impact on PE (private equity) sponsors' internal rate of return, so these firms often have professional staff focused on negotiating rates and terms. PE sponsorship is more prevalent among large borrowers than smaller ones, which again puts pressure on rates for large loans.

The upshot is that rates for smaller borrowers are expected to be higher than for larger ones—i.e., smaller loans may enjoy a yield premium. As discussed next, this is borne out by empirical evidence.

[5] We use the terms "borrower size" and "loan size" interchangeably, as these two concepts are highly correlated in practice.

[6] Private Debt Investor, December 1, 2023.

Empirical Evidence Supports the Small-Cap Loan Premium

The magnitude of the premium associated with smaller loans has been documented in a study by Cliffwater Investments [Exhibit 2]. Based on data covering the period 2016 to 2022, lower-middle-market loans enjoyed an average 2.1% yield premium over upper-middle-market loans.[7]

The same study also documented a "non-sponsor borrower premium," which consisted of an additional 2.3% yield for non-sponsored borrowers versus PE-sponsored ones.

In practice, small-cap borrowers are predominately not PE-sponsored, in which case the premium would be the sum of the two premia and can exceed 4%.

Empirical evidence suggests small loans on average enjoy a 2% premium. This premium is amplified for small borrowers that are not PE-sponsored.

EXHIBIT 2

Small-Cap Loans and Non-Sponsored Borrowers Have Historically Enjoyed a Risk Premium

Type of Premium	Yield Premium June 2016–March 2022
Smaller Loans vs. Larger Loans	Average: 2.1% Range: 1.6%–2.9%
Non-Sponsored vs. PE Sponsored*	Average: 2.3% Range: 1.7%–3.0%

Source: Nesbitt, *Private Debt: Yield, Safety and the Emergence of Alternative Lending.*

[7] While the study only documents the difference between upper- and lower-middle-market loans, it stands to reason that the size effect would extend further as loan size decreases even further.

Cash-Flow-Based versus Asset-Based Underwriting as an Essential Dimension of Risk

Underwriting method is the second dimension in our two-by-two framework. We classify underwriting methodologies into two broad camps: cash-flow-based underwriting and asset-based underwriting. While loan approvals often consider elements of both methods, the final approval of the maximum loan size usually hinges on either cash flow or asset collateral.

For cash-flow-based underwriting, a lender's highest priority is determining whether the borrower has sufficient cash flow to cover the interest payments for the loan. Businesses such as technology or professional services tend to be underwritten using cash-flow-based criteria, since they have high earnings with few tangible assets.[8]

In contrast, asset-based underwriting relies on the value of specific collateral pledged by the borrower. This extends beyond what is classically called asset-based lending—i.e., loans backed by inventory, equipment, and receivables—to other segments that go by different names, such as real estate lending, infrastructure lending, trade finance, and many more.

The primary difference between these two underwriting paradigms comes to the fore in the case of distress of an individual borrower or in economy-wide downturns or credit crunches. As shown in Exhibit 3, the presence of pledged collateral for asset-based lending may provide a defined source of repayment and better recovery rates than relying on declining cash flows.

The key difference between these two paradigms is the source of repayment in times of distress.

EXHIBIT 3

Asset-Based Underwriting vs. Cash-Flow-Based Underwriting: Differences Emerge in Times of Distress

	Asset Based	Cash Flow Based
Primary basis for underwriting	Percentage of the value of assets or Loan-to-Value (LTV)	Ratio of borrower's earnings to interest payments (debt coverage)
Ability to achieve full loan recovery	Separate from borrower's performance	Dependent on borrower's performance
Source of repayment in stress periods	Pledged collateral, e.g., equipment, inventory, receivables, real estate, aircraft, etc.	Borrower earnings and enterprise value

[8] Cash-flow-based funds sometimes quote loan-to-value ratios for their loans based on "enterprise value," even though the value is based on cash flow rather than the value of a tangible asset.

Pulling It All Together: Applying the Two-by-Two Framework to Optimize a Private Credit Portfolio

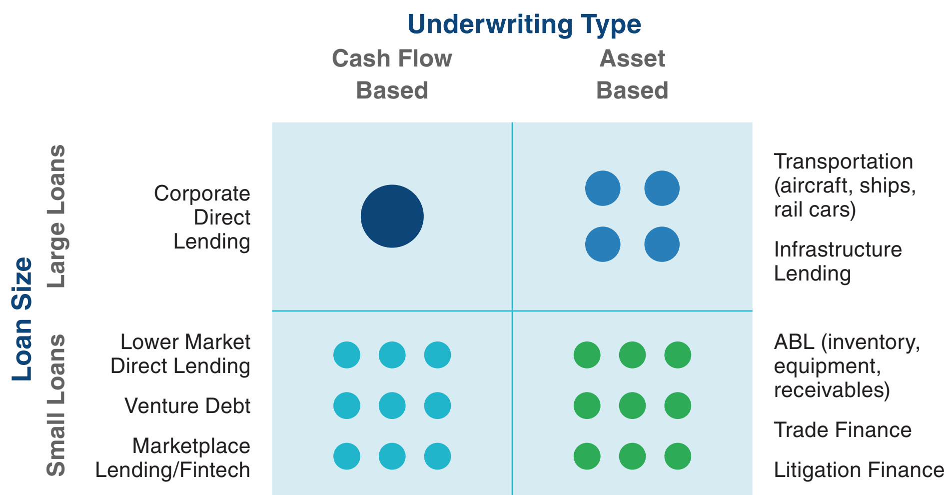
For investors seeking to diversify beyond corporate direct lending, we believe that our framework provides a useful first cut for grouping potential investments with different risk-return characteristics. In Exhibit 4, we have sorted some of the better-known private credit strategies into the four quadrants of our framework for illustrative purposes.[9]

While a final investment decision in a fund needs to take into account additional considerations, we believe the large vs. small, asset based vs. cash flow based distinction may be as useful to private credit investors as the Large/Small Growth/Value paradigm is for equity investors. This grouping of private credit segments by loan size and underwriting type can help investors optimize their private credit exposure when diversifying beyond corporate direct lending.

The two-by-two framework provides a first cut for identifying commonalities and differences between different market segments and making intentional decisions that maximize diversification.

EXHIBIT 4

The Framework Applied to Some Common Private Credit Segments *(Illustrative)*



[9] We classified segments based on the characteristics most common for the strategy in question, but the classification applies to the specific characteristics of any given fund in question. For example, the spectrum of real estate loans is so diverse that we show it in both size buckets.

Disclosures

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