



# Opportunities in Private Credit Webinar

August 20, 2020

---

**Catherine Beard, CFA**  
Alternatives Consulting Group

**Weston Lewis, CFA, CAIA**  
Fund Sponsor Consulting

**Nathan Wong, CFA**  
Global Manager Research

---

## Presenters



Catherine Beard, CFA

Weston Lewis, CFA, CAIA

Nathan Wong, CFA

# Distressed Credit Cycle Has Arrived



- The late-stage credit cycle shifted in early 2020
- COVID-19-related dislocations are driving widening spreads, tighter credit, and rising defaults
- Credit-focused investment opportunities are emerging, with equity-like returns

---

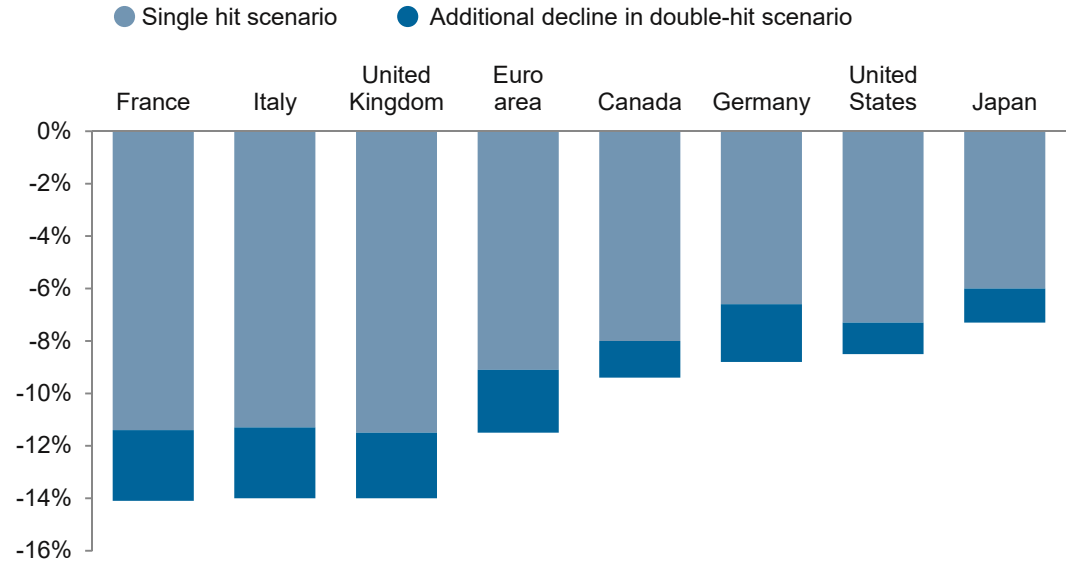
## **Anatomy of a Dislocation**

Nathan Wong, CFA

# COVID-19 Macroeconomic Effects = Global Slowdown

- Global economy has experienced most severe contraction in decades
- Pandemic and restrictions on movement have exacted a toll on economic activity
- Rising debt levels may create additional headwinds going forward

## 2020 Projected Change in GDP

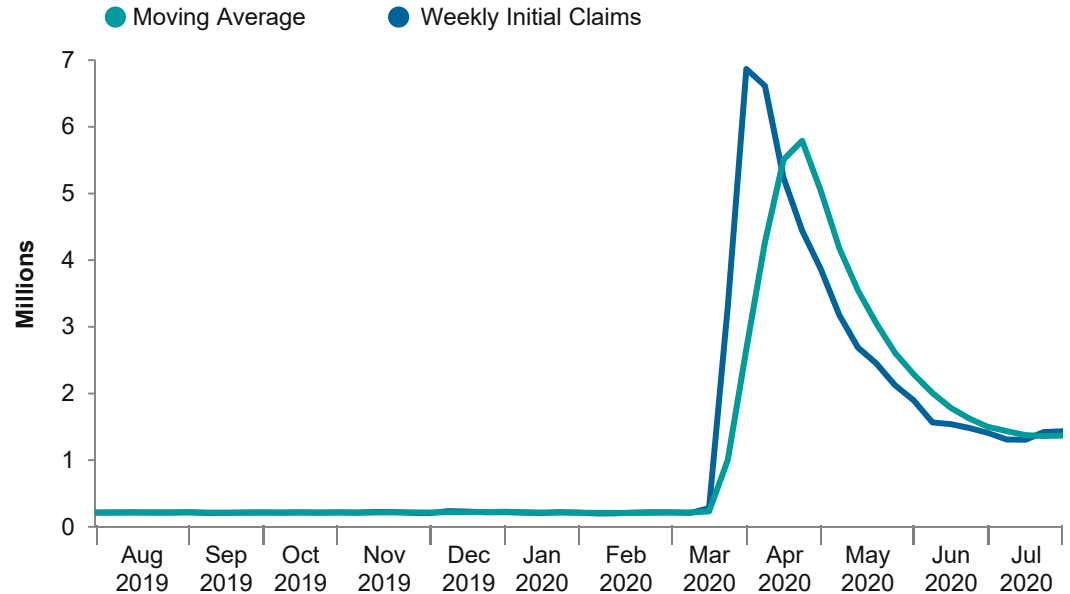


Source: OECD; <https://www.oecd.org/economic-outlook/>

# COVID-19 Macroeconomic Effects = Battered U.S. Employment

- Jobless claims rose abruptly following the initial shutdown
- U.S. unemployment rate has fallen since April as many businesses reopen and rehire
- Jobless rate remains above the Global Financial Crisis peak of 10.0%, and more than double February's 3.5%

**Seasonally Adjusted Unemployment Insurance Initial Claims**  
(July 27, 2019 – July 25, 2020)

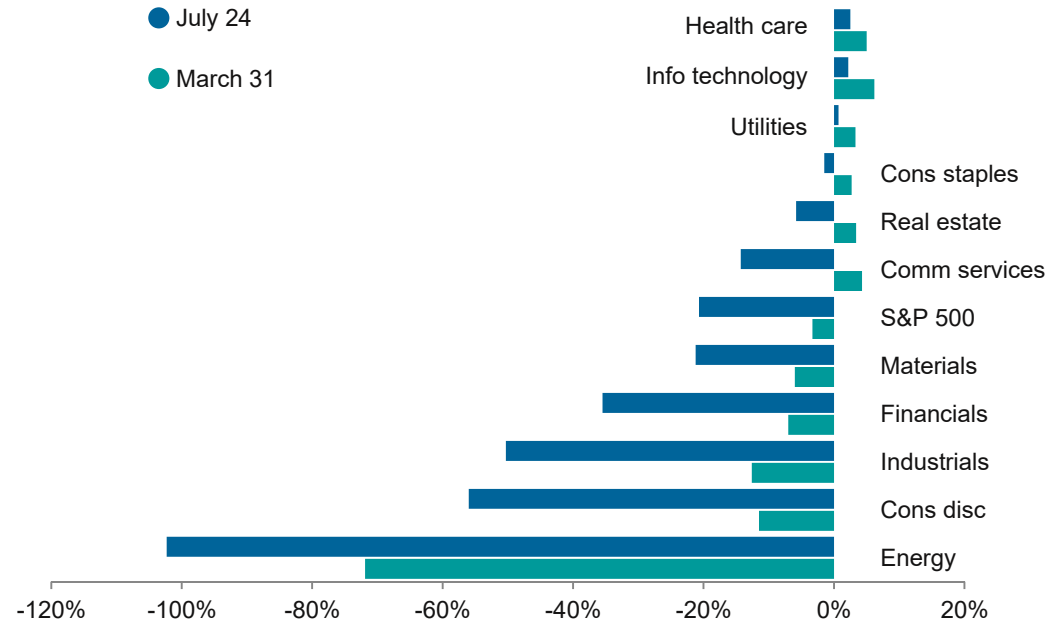


Source: Department of Labor, <https://www.dol.gov/ui/data.pdf>

# COVID-19 Macroeconomic Effects = Steep Earnings Slowdown

- In aggregate, companies are expected to report a 43% drop in profits for second quarter
- Profit margins projected to be the lowest since the end of 2009
- Many businesses burdened with fixed costs and increased costs to reopen

S&P Earnings Growth: Calendar Year 2020



Source: FactSet

# Oil Markets Most Immediately Impacted

- Oil prices fell precipitously on OPEC / Russia negotiations and slowing demand
- 90% of energy market estimated to be distressed

## Change in Production and Consumption of Liquid Fuels (millions of barrels per day)

	2017	2018	2019	2020	2021	Growth since 2017
<b>Production</b>						
U.S.	15.7	17.9	19.5	18.6	18.1	15.4%
OPEC	36.8	36.8	34.7	31.3	33.2	-10.0%
Russia	11.2	11.4	11.5	10.5	11.0	-2.0%
<b>Global</b>	<b>98.1</b>	<b>100.8</b>	<b>100.7</b>	<b>94.8</b>	<b>97.4</b>	<b>-0.7%</b>
<b>Consumption</b>						
U.S.	20.0	20.5	20.5	18.1	19.5	-2.5%
China	13.6	14.0	14.5	13.6	15.3	12.9%
<b>Global</b>	<b>98.8</b>	<b>100.0</b>	<b>100.9</b>	<b>92.5</b>	<b>99.7</b>	<b>1.0%</b>
<b>Inventory Change</b>	<b>-0.6</b>	<b>0.8</b>	<b>-0.2</b>	<b>2.2</b>	<b>-2.3</b>	

Sources: J.P. Morgan Asset Management, EIA, Bloomberg, Baker Hughes

## Price of Oil (WTI crude, nominal prices, USD / barrel)





# Rapid Deterioration in High Yield and Leveraged Loans

- Early stages of crisis characterized by extreme volatility
- Yield spreads have narrowed from peak but cycle expected to be long due to scale of dislocation
- Liquidity squeeze from deleveraging and forced selling has caused massive repricing
- Opportunities to acquire assets in the secondary market at significant discounts

	January 31, 2020	March 18, 2020	Today
High Yield Spread to Worst	375 bps	1,100 bps	515 bps
Leveraged Loan Index Price	\$97	\$75	\$89
Industries with Distressed Credits	Energy, Retail	All	All
2020 Fallen Angel Volumes	\$25bn	\$150bn	\$500bn+(E)
Downgrade-to-Upgrade Ratio	2x	8x	43x
Distressed Ratio	4%	40%	15%
Default Rate	2%	2%	6% currently, 18% (E)

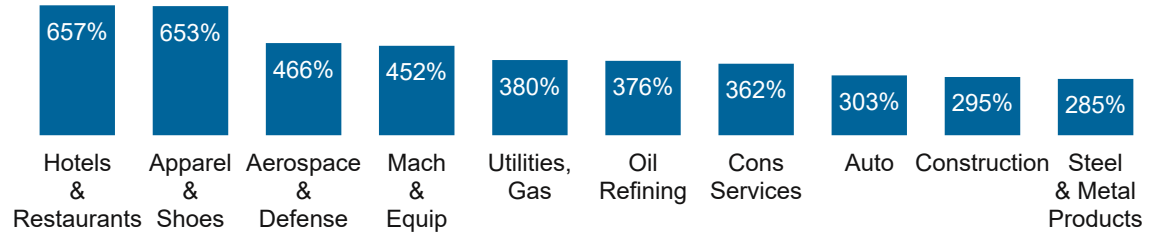
Sources: Bloomberg, Marathon Asset Management; as of June 30, 2020

# Impact Felt Across Sectors

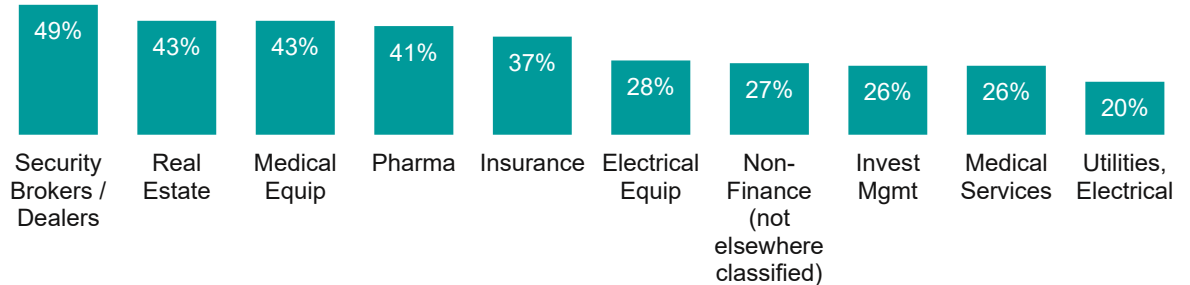
## Expected default frequencies

- Expected default frequencies (EDF) have increased across industries
- Impact greatest among leisure, travel, retail, and energy firms
- “Essential” businesses feel less of a strain

EDF Change between 01/01/20 and 03/24/20 (Top 10)



EDF Change between 01/01/20 and 03/24/20 (Bottom 10)



Source: Moody's Analytics, <https://ma.moody.com/rs/961-KCJ-308/images/Tracking%20the%20Impact%20of%20COVID-19%20on%20Credit%20Risk.pdf>

# Slowdown Portends Higher Defaults

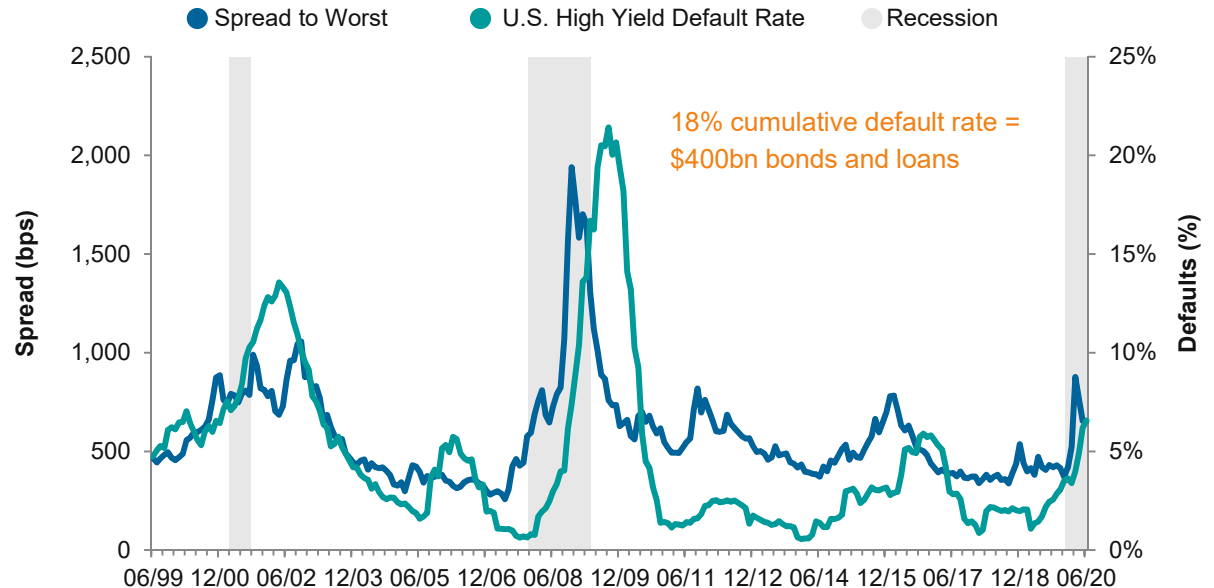
## U.S. high yield bond defaults

Market entering another distressed cycle; spreads in excess of 1,000 bps

- In March, USD-denominated debt trading at distressed levels exceeded that of the GFC
- Several industries—beyond those directly impacted by COVID-19—will likely experience higher defaults

**Expectations:** \$500bn of BBB fallen angels; \$400bn of high yield loans / bonds downgraded to CCC; \$560bn of high yield to default

### U.S. High Yield Bond Defaults



Sources: Bank of America Merrill Lynch, Marathon Asset Management; as of May 2020

## Fed Providing Meaningful Support to Certain Markets ...

Program/Facility	Targeted Sector	Purchases, direct lending, or SPV	Announced Treasury support (\$bn)	Current Balance (\$bn)
Corporate Credit Facilities	Corporate Debt	SPV	\$750	\$12
Main Street Loan Facilities	Small- & Mid-Sized Businesses	SPV	\$600	\$0.9
Municipal Liquidity Facility	Municipal Debt	SPV	\$500	\$1
Commercial Paper Fund Facility	Commercial Paper	SPV	\$10	\$0.3
Money Market Mutual Fund Liquidity Facility	Money Market Mutual Funds	SPV	\$10	\$14
Term Asset-Backed Securities Loan Facility	Asset-Backed Securities	SPV	\$10	\$2
Asset Purchases	Treasuries, Agency MBS	Purchases	\$0	\$1,511
Paycheck Protection Program Liquidity Facility	Small Businesses	Direct Loans	\$0	\$71
Primary Dealer Credit Facility	Primary Dealers/Liquidity	Direct Loans	\$0	\$1,188
Discount Window	Banks	Direct Loans	\$0	\$36
Central Bank Swap Lines	Central Banks/Dollar Liquidity	Direct Loans	\$0	\$378
FIMA Repo Facility	Foreign Monetary/Treasury Liquidity	Direct Loans	\$0	-
Repurchase Agreements	Financial Intermediaries	Direct Loans	\$0	\$181
<b>Totals</b>			<b>\$1,880</b>	<b>\$3,395</b>

Sources: Marathon Asset Management, SIFMA

## ... While Excluding Others

Asset Type	Market Size (\$bn)	Fed Facility Size (\$bn)	Fed Eligible?
HY Bonds	\$1,300	None	No
HY ETF	\$42	\$8	Limited
Leveraged Loans	\$1,400	None	No
Leveraged Loans ETF	\$10	None	No
CLO AA-Unrated	\$335	None	No
European HY Bonds and Loans	\$700	None	No
Fallen Angels <BB	TBD	None	Limited
Middle Market Loans	\$1,000	\$200(E)	Limited
<b>Total Ineligible Assets</b>	<b>\$4,787</b>		

The Fed and Treasury have been quick to provide solutions to certain parts of the market, primarily short-term and investment grade securities. However, the lack of support for leveraged credit markets and high yield bonds creates opportunities for distressed investors.

Sources: Marathon Asset Management, SIFMA. Note HY ETF assets have very limited eligibility.



---

# Strategies and Opportunities

Catherine Beard, CFA

# Private Credit

## Primary strategy categories

<b>Corporate Direct Lending</b> (Non-Syndicated), Mezzanine	Commercial loans to finance general business operations, specific projects, or growth opportunities
<b>Real Assets Lending</b>	Loans backed by real estate, aviation, shipping, and other infrastructure projects
<b>Structured Credit</b>	Pools of corporate and other asset-backed loans including corporate, consumer, and residential-related structures; cash flows segregated into different credit tranches
<b>Distressed Debt / Special Situations</b>	Invests across the capital structure in stressed or distressed companies, often to create value through actively driving a restructuring
<b>Specialty Finance</b>	(Consumer lending, franchise lending, specialty lending, etc.) Loans backed by more esoteric forms of collateral, usually requiring specialized expertise
<b>Other Niche</b>	(Insurance-linked, life settlements, royalties) Debt-related investing in niche sectors such as insurance and health care royalties
<b>Multi-Strategy</b>	Investing in the private credit subcategories outlined above; allocations may change opportunistically over time

# Varying Opportunities as Cycle Evolves

<b>Current Period (I)</b> ( <i>&lt; 1 year</i> ) Dislocation/Illiquidity	<b>Intermediate Period (II)</b> ( <i>&lt; 2 years</i> ) Exit Paths Emerge	<b>Extended Period (III)</b> ( <i>1 – 3+ years</i> ) Restructuring & Recovery
<p data-bbox="104 347 539 369"><b>Maximum uncertainty and dislocation</b></p> <p data-bbox="104 434 311 456"><b>Investment Focus</b></p> <ul data-bbox="104 478 595 543" style="list-style-type: none"><li>- Aim for highest-quality credits trading down</li><li>- Capital structure dislocations</li></ul> <p data-bbox="104 692 324 714"><b>Key Manager Skills</b></p> <ul data-bbox="104 736 421 801" style="list-style-type: none"><li>- Trading</li><li>- Relative value assessment</li></ul>	<p data-bbox="701 347 1180 408"><b>Potential outcomes narrow: deeper credit underwriting and opportunistic lending</b></p> <p data-bbox="701 434 908 456"><b>Investment Focus</b></p> <ul data-bbox="701 478 1209 663" style="list-style-type: none"><li>- Corporate stress and distress</li><li>- Crossover opportunities; integration of credit and asset underwriting</li><li>- Structured credit</li><li>- Private credit</li></ul> <p data-bbox="701 692 923 714"><b>Key Manager Skills</b></p> <ul data-bbox="701 736 933 888" style="list-style-type: none"><li>- Deal origination</li><li>- Security selection</li><li>- Credit underwriting</li><li>- Legal / workouts</li></ul>	<p data-bbox="1298 347 1798 408"><b>Managers seek to improve recoveries; turnaround and restructuring opportunities</b></p> <p data-bbox="1298 434 1505 456"><b>Investment Focus</b></p> <ul data-bbox="1298 478 1816 626" style="list-style-type: none"><li>- Corporate restructurings</li><li>- Non-performing loan portfolios and structured credit work-outs</li><li>- Alternative and special situations lending</li></ul> <p data-bbox="1298 692 1520 714"><b>Key Manager Skills</b></p> <ul data-bbox="1298 736 1779 845" style="list-style-type: none"><li>- Ability to identify / acquire fulcrum security</li><li>- Operational turnaround</li><li>- Ability to exit</li></ul>



# Managers and Strategies Available

## Open-Ended Structure

Opportunistic Credit	Distressed Credit	Multi-strategy	Specialty Finance
Middle market stressed / distressed and special situations. Focus on more liquid assets such as high yield bonds and broadly syndicated loans as well as illiquid restructuring opportunities.	Absolute return-oriented credit strategy. Invests across credit sectors, geographies, and instruments (e.g., HY bonds, loans, structured products, distressed debt).	Multi-strategy hedge fund that invests in merger arbitrage, credit, capital structure arbitrage, hedged credit and equities with catalysts.	Asset-based, specialty finance strategy utilizing deep fundamental expertise as well as highly quantitative underwriting and portfolio construction processes.

## Drawdown Structure

Opportunistic Direct Lending	Multi-strategy	Core Direct Lending
Opportunistic lending to middle- and upper-middle-market companies on a global basis.	Corporate securities, loan portfolios, structured credit, hard assets. Quality assets at distressed prices, orphaned asset sales, and distressed restructurings.	Focus on providing senior and unitranche debt financing to private equity sponsor-backed middle market companies.



---

## **Asset Allocator Point of View**

Weston Lewis, CFA, CAIA

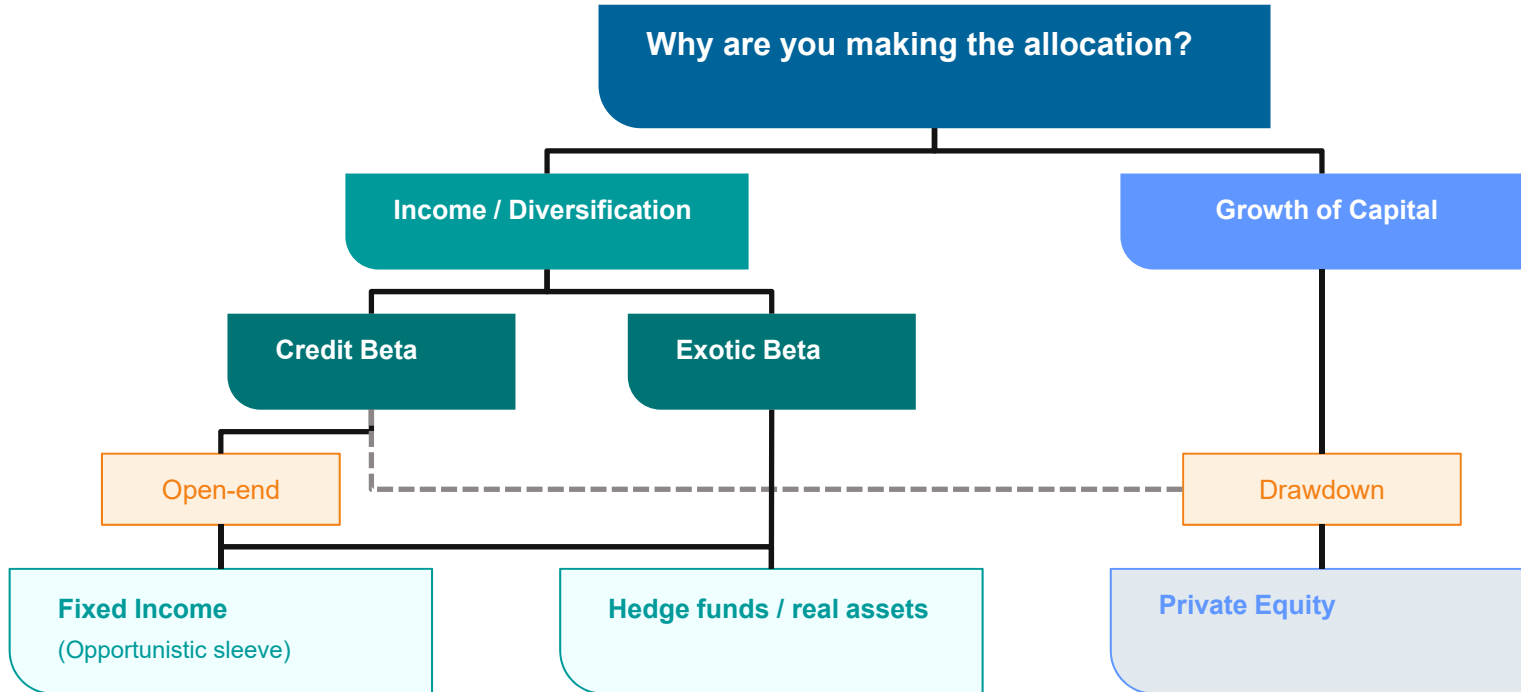
# Where Does Private Credit Fit?

- Technically these are debt instruments, but...
  - Be mindful of the credit risk and the positive correlation with equity
  - The fund structure matters (open-end vs. drawdown)
- Current asset allocation construct
  - Strategic vs. opportunistic?
  - Fixed income complement?
  - Hedge funds / real assets?
  - What about private equity?



# Evaluating the Fit

Considerations for bucketing the allocation to private credit strategies



## Client Case Study

### Corporate defined benefit plan

- \$8 billion in assets
- ~80% funded
- Broad asset allocation remains return-seeking
- Alternatives and private equity allocations currently underweight relative to the target

#### Public Equity

50% Global Equity

#### Alternatives

10% Private Equity  
10% Other Alternatives  
(hedge funds and real assets)

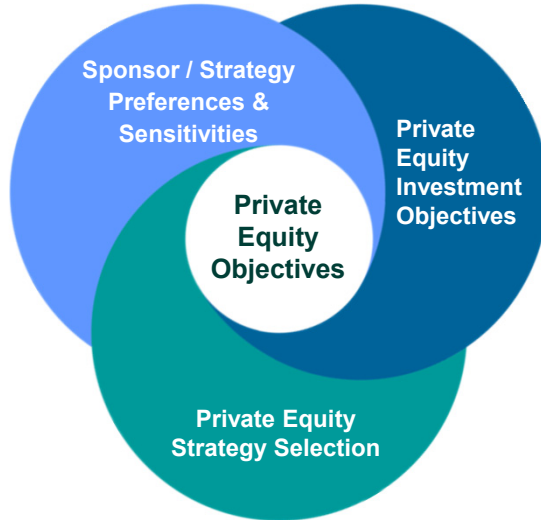
#### Liability-Hedging

30% Long Gov / Credit

# Client Case Study

## Private equity objectives

- Stable private equity sponsors with demonstrable track records
- Strong performance
- Complementary strategies must be compelling against relevant peer group, as well as buyout opportunities



High quality, “all-weather” private equity portfolio

- Primary focus on large diversified buyouts, with a mix of value-creation mechanisms
- Secondary consideration of complementary strategy types

- Rationalized private credit as complement to broader private equity program
- Environment less conducive to buyout fundraising, more conducive to opportunistic strategies
- Opportunistic allocation—must meet underwriting criteria and due diligence standards (~15% net IRR)
- Also helps to mitigate some effects of J-curve, diversifies return drivers, helps fund up the program

---

## Conclusion

- Client sees current landscape as a once-in-a-decade opportunity with targeted returns on par with private equity
- Private credit strategies can play a role in several categories—not just limited to fixed income
- Considerations:
  - Drawdown fund structures make benchmarking a challenge when paired with public asset classes
  - Due diligence and underwriting process requires significant time commitment
  - Illiquidity, though less severe than private equity, still pales in comparison to public markets



# TAKEAWAYS

- The COVID-19 crisis is impacting businesses across sectors and around the globe. There are a few places to hide.
- Government support is focused on specific sectors and asset classes, creating opportunities for distressed investors to fill the gaps.
- As the distressed credit cycle evolves, opportunities will emerge for different private credit strategies.
- Investing in private credit is not for everyone. Asset owners need to follow a due diligence process to find the right fit.



---

## Biographies

**Catherine Beard, CFA**, is a senior vice president and member of the firm's Alternatives Consulting team. Based in Callan's Chicago office, Catherine provides consulting and research across alternatives, with a particular focus on private credit and diversifying strategies. She is a member of the Callan Inclusion Committee. She is also a holder of the right to use the Chartered Financial Analyst® designation.

**Weston Lewis, CFA, CAIA**, is a senior vice president in Callan's Atlanta Fund Sponsor Consulting office. Weston works with a variety of fund sponsor clients across the Southeast region, including defined benefit plans, defined contribution plans, insurance assets, endowments, and foundations. His responsibilities include client service, investment manager reviews, performance measurement, research and continuing education, business development, and coordination of special client proposals and requests. Weston is a member of Callan's Client Policy Review Committee and is a shareholder of the firm. He is a holder of the right to use the Chartered Financial Analyst® designation and is a member of the Atlanta Society of Finance and Investment Professionals. Weston has also earned the right to use the CAIA designation.

**Nathan Wong, CFA**, is a vice president and investment consultant in Callan's Global Manager Research group, specializing in fixed income and private credit. He is responsible for researching and analyzing fixed income and private credit investment managers, and he assists plan sponsor clients with fixed income and private credit manager searches. In this role, Nathan meets regularly with investment managers to develop an understanding of their strategies, products, investment policies, and organizational structures. He is a shareholder of the firm. Nathan is a holder of the right to use the Chartered Financial Analyst® designation and is a member of the CFA Institute and the CFA Society of San Francisco.



**The Callan Institute's mission is to improve the best practices of the institutional investment community through research, education, and dialogue.**

---

Follow us for notifications about our latest research and events



Twitter: @CallanLLC



LinkedIn: Callan



## Upcoming Webinars

### **Private Equity**

October 7, 2020

Register at: [www.callan.com/events](http://www.callan.com/events)