CAPITAL CREEK STRATEGY – MARCH 2024

The Golden Age of Credit

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About Scott Slayton

Partner, Chief Strategist

Scott is a partner of the firm and Chief Strategist. Before joining Capital Creek, Scott was the Head of Asset Allocation at UTIMCO, where he served on the firm's Management, Investment, and Risk Committees. Scott has 35 years of investment experience as a strategist, portfolio manager, and asset allocator. Scott spent most of his career in New York, working at Kidder Peabody, Morgan Stanley, and Tudor Investments. Scott studied at the University of Texas at Austin, where he received a BBA in finance in 1988. Scott is also a Chartered Financial Analyst, CFA.

About Capital Creek Partners

A Private Investment Firm, Founded by Families.

We are an investment partner organized to serve the needs of family offices, foundations, endowments, and private investment companies. Established in 2018, Capital Creek Partners was founded as a boutique multi-family office to serve a small number of prominent families. Our firm's culture is rooted in Integrity, Humility, and Excellence.

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**ChatGPT was a research assistant in the writing of this report.*

Austin, TX – March 4, 2024

"Credit, through history, has been the invisible bridge between ambition and achievement, powering economies, fostering innovation, and weaving the fabric of human progress, yet always shadowed by the delicate balance of trust and risk."
- Anonymous

Executive Summary

Credit markets in the US have been undergoing profound changes since the Global Financial Crisis ("GFC"). Banks have become disadvantaged and forced to de-risk due to Basel III regulatory burdens, Dodd-Frank legislation, and higher interest rates. Public debt issuance has taken up some of the slack, but this option is mostly available to the largest and highest quality issuers. Corporate balance sheets are still early in the process of adjusting to a higher cost of capital. Private credit solutions have stepped in to fill the gap, creating an attractive and innovative place for investors to earn elevated risk-adjusted returns. We believe the high growth trajectory for private credit will persist for the next 3-5 years as money is destined to remain significantly tighter than it was during the extremely easy money period from 2009 through 2021. Welcome to ***The Golden Age of Private Credit.***

Exhibit 1: (Fed Funds Rate) The End of Easy Money Has Been Supportive of Private Credit Growth

Source: Capital Creek Research, Bloomberg

As the Chief Strategist at Capital Creek, I have been studying the private credit markets while underwriting potential private credit managers for our clients. During this study period, I have discovered positive underlying fundamentals, trends, and technical factors that make private credit an especially fertile area for investment. We believe the demand for capital will exceed the supply of available capital well into the future. This is a natural reaction to the era of easy money that encouraged

borrowers to take on too much debt. As interest rates shot back to more normal levels in 2022 and 2023, this left quality businesses with holes in their balance sheets. Skilled and properly resourced private credit managers can rectify these balance sheet problems under very favorable terms that allow them to earn double-digit yields while protecting their downside.

Professionally managed private credit investments can combine high credit quality, attractive yield, strong collateral, well-designed protective covenants, diversification, and low volatility. Institutional investors are now seeking this powerful combination in ever greater size and scale. According to a recent Preqin survey, 45% of institutional investors plan to increase their exposure to private credit over the next 12 months.

I can remember reading Shakespeare's Merchant of Venice as a young man and learning difficult lessons about borrowing and lending money. "Let the forfeit be nominated for an equal pound of your fair flesh to be cut off and taken." Credit is ancient and is the foundation of all financial activity. While lending has become far more innovative and complicated in our modern financially based economy, it still comes down to understanding the quality of a borrower's underlying business, cash flow, collateral, and ability or willingness to pay back. Credible estimates from well-known institutions indicate that the private credit market could double over the next five years (see Exhibit 2). Even if the private credit market doubles, it will still be small in the context of global banking sector balance sheets and global fixed income outstanding (see Exhibit 3).

Exhibit 2: Private Credit is Projected to Grow Rapidly

Global Private Credit AUM on Track to Reach ~$2.8T by 2028

Source: Preqin, TPG

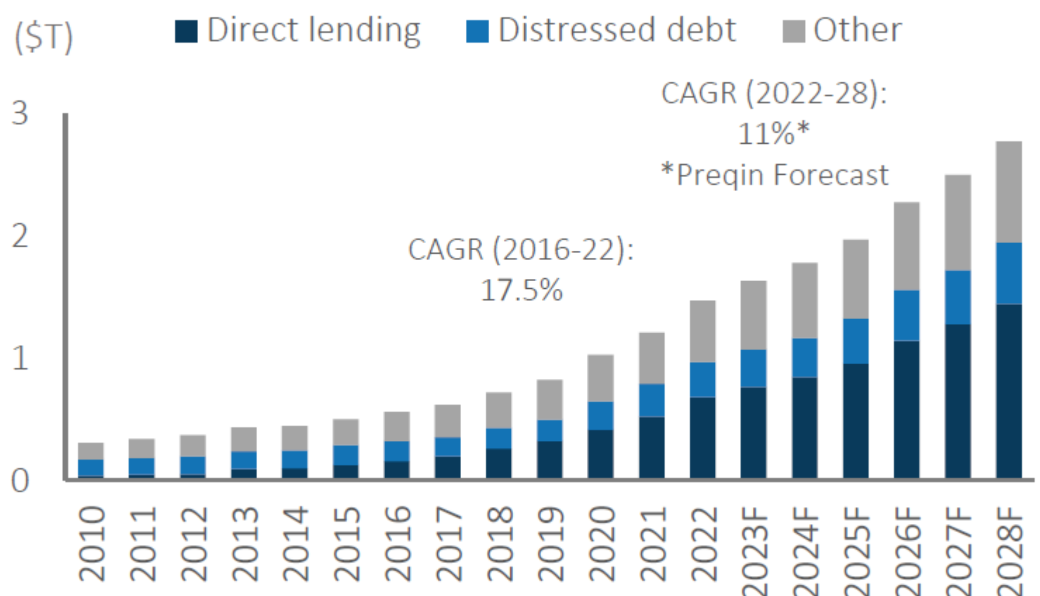
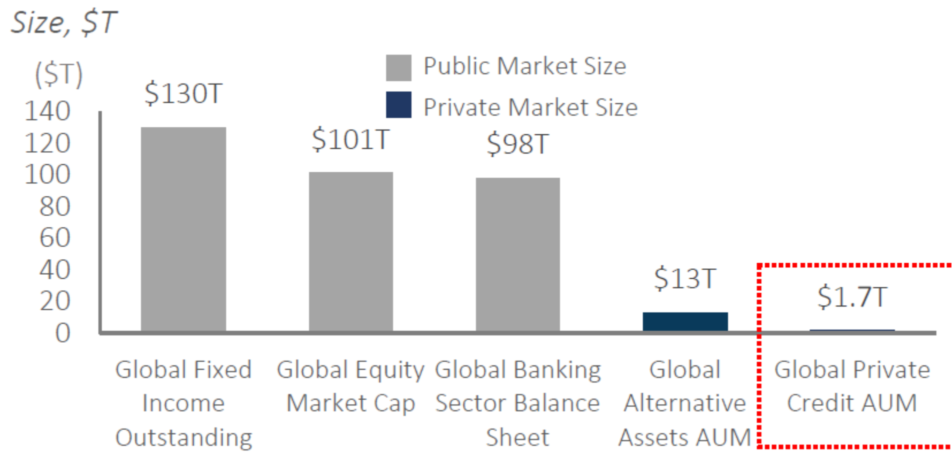


Exhibit 3: Private Credit Has Ample Room to Grow

The Size of Private Credit Remains Modest Relative to Public Markets

Source: SIFMA, BIS, PitchBook, TPG

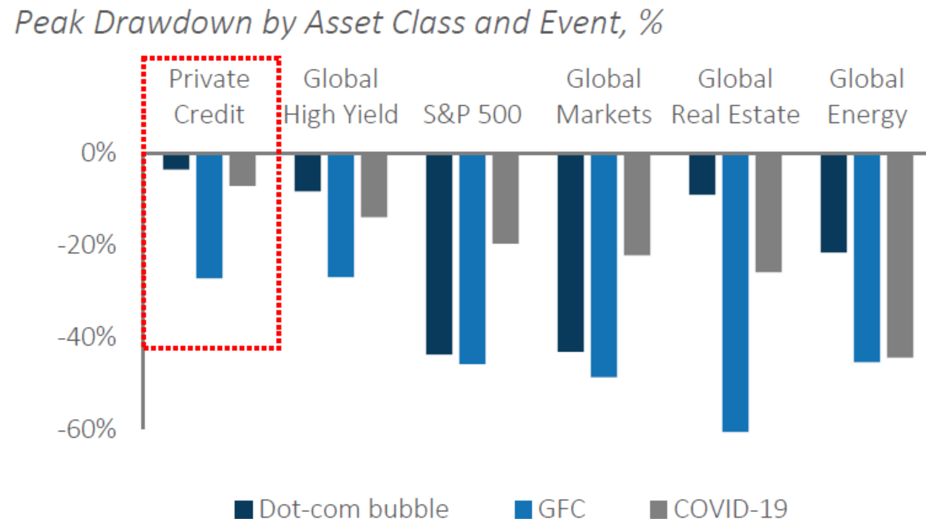


At Capital Creek, we believe private credit should play a key role in client portfolios and can become a larger portion of the overall fixed income allocation. The best private credit managers recently navigated through the worst fixed income bear market in modern history in 2022 and 2023, in many cases producing significantly positive returns in both years. For clients without immediate liquidity needs, including most family office clients, private credit can add a very meaningful step up in yield, the potential for capital appreciation, and relatively high risk adjusted returns. Allocations to private credit can allow the investor to opportunistically deploy capital during periods of distress when capital is especially dear, and the returns tend to be the strongest. Opportunistic private credit funds give investors the ability to generate yield, play good defense, and bring the offensive team onto the field during times of distress. We believe risk adjusted returns in private credit today are highly competitive with public equity and even private equity returns. To quote Michael Milken, ***"When you can earn double digit returns in credit, it is unnecessary to incur the additional risk of owning equity."***

Exhibit 4: Private Credit Has a History of Outperforming on the Downside

Private Credit Has Weathered Past Downturns Well

Source: PitchBook, TPG



Risks to the Golden Age Thesis

In finance, we know there can be no monetary reward without taking risks. We have identified the following risks to our credit thesis. The greatest risk to our *Golden Age* thesis is too much capital pouring into the asset class too quickly, thus lowering returns. Increasing competition weakens credit covenants and could upend the currently favorable supply/demand imbalance that favors lenders over borrowers. We are seeing more credit deals come across our desk and many are being "upsized" to take on more capital. I do not think we have approached a tipping point, because agreed upon terms have not yet deteriorated in favor of the borrowers. From our vantage point, credit underwriting standards remain robustly conservative and lender friendly. There is a gargantuan $1.6 trillion wave of non-investment grade debt maturing in the 2024-2026 period, which should keep supply and demand in favor of the lenders. Next, regulation is a potential risk for private credit. Regulators have shifted risk from banks to non-bank financial institutions. As non-bank financial institutions grow in size and profitability, the risk of greater regulation increases. Another low probability risk is the Fed stays too tight for too long, an economic recession sets in, and a deflationary mindset takes hold. We see the probability of a recession this year below 20% due to a robust labor market, falling inflation, strong fiscal spending, rising productivity, and record consumer net worth. Credit should perform well given the macro backdrop, and we see the above risks as manageable.

Because private credit investment is a clear, robust, and durable theme, our strategy has been to find the highest quality managers with experience and deep resources. Of course, we also want to add in smaller, more nimble managers who will be finding opportunities below the pay grade of the large blue-chip players such as Apollo. At Capital Creek, we are well positioned to find the smaller diamonds in the rough that focus on lower middle market credit where outsized returns can be produced. Most of all, we want our clients to meaningfully participate in the durable positive trend we see continuing in private credit markets.

Comparing Public Credit to Private Credit

Given our public market background, we tend to compare private market assets to public markets to try to identify discontinuities of value. We have recently looked carefully at public credit markets and found them much less attractive than their private market competition. While public credit market fundamentals look robust and yields are high compared to the era of easy money, spreads are at historically tight relative to Treasury paper of similar maturities. We believe significantly more value and credit protection can be created in the private markets where smaller quality borrowers do not have easy access to the public markets. Today, BBB-rated investment grade paper yields approximately 5.0%-to-5.5% in the public markets, while paper of similar credit quality yields 10%-to-12% in the private markets. It

should be mentioned that public markets offer a better liquidity profile compared to the private market. In a sense, investors give up liquidity for much higher yields and stronger downside protection in the private markets. This seems like a particularly good tradeoff for investors who can capitalize on it under the current circumstances.

The charts below tell us five important things:

1. We see little value in public credit relative to the yields we can find in private credit.
2. Public credit investors are not being compensated enough for taking on lower rated credits.
3. The US economy is in solid shape and public credit investors are not concerned about a significant deterioration in credit quality on the horizon.
4. Central bank liquidity has returned to the system, lifting all risk assets.
5. Public credit investors, like equity investors, are complacent about future risks.

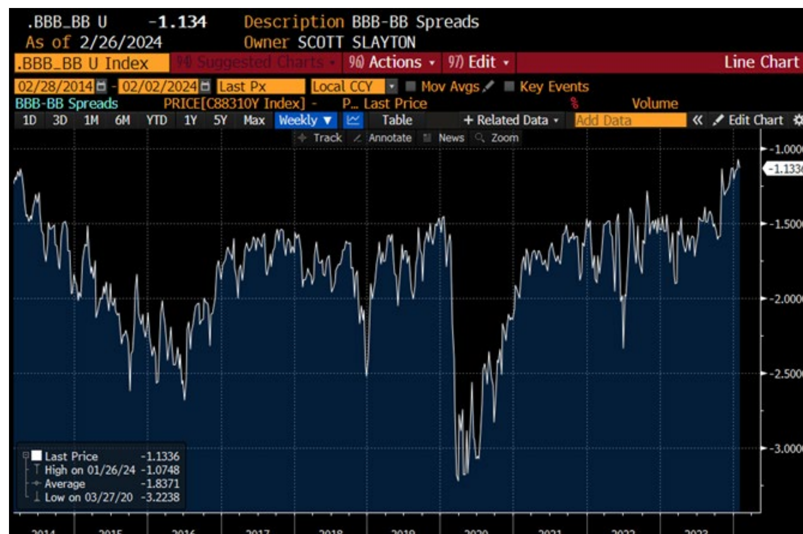
Exhibit 5: US Corporate BAA Credit to 10-Year Treasury Spreads

Extremely tight spreads between investment-grade credit and Treasury Bonds reveal a lack of relative value in investment-grade public credit.

Source: Bloomberg, Capital Creek Research

Exhibit 6: The Spread Between BBB Rated Bonds and Lower-Rated BB Bonds is the Tightest in a Decade

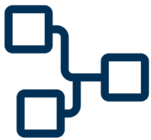
Source: Bloomberg, Capital Creek Research



Waiting for Godot

Our macro read of the situation is that those waiting for a recession to find deeply distressed opportunities will likely be disappointed. There is not enough money good, distressed paper to satisfy all the dry powder waiting to invest at yields greater than 20%. Some distressed funds are even returning capital. The US economy continues to be resilient and grow at trend or higher. The robust labor market and rising real wages are enabling the US consumer to continue to spend. With the Fed still likely to lower policy rates in the second half of the year, risk appetite remains strong. Better to get "money in the ground" at current attractive low teens yields on high quality paper. In *the Golden Age of Private Credit*, the key is to participate in the sweet spot of opportunistic private credit with high quality managers. Those waiting for windfall type returns in distressed situations are likely to remain frustrated as the "Godot Recession" repeatedly fails to materialize.

Subcategories we Favor in Private Credit



Private credit has many different areas of specialization including Direct Lending, Business Development Companies or BDCs, Collateralized Loan Obligations or CLOs, Distressed Debt, Asset Backed Securities or ABS, and Mezzanine funds. This alphabet soup of opportunities can be difficult for a non-specialist to navigate. We are focused on underwriting "opportunistic" credit managers that have the mandate and resources to navigate the entire asset class and go where they find the best risk adjusted opportunities available.

Our current portfolio construction in private credit covers senior secured direct lending all the way through distressed credit. Some of the best managers we are underwriting favor lending to good companies with challenging balance sheets created by over levering during the "Era of Easy Money." These semi-distressed companies need refinancing to allow their businesses to recover or navigate to a period of lower interest rates. In these complex transactions that often take months to complete, private lenders can carve out first liens on crown jewel assets to lend against, can write contracts with very strong covenants, and still command highly attractive yields. The borrowers are willing to agree because they are confident in their underlying business prospects, do not want to issue equity, and need the money quickly. Nimble and well-resourced private credit firms are comfortable with complexity and can get money to borrowers fast under favorable terms.

Conclusion

There are structural forces that are currently favoring private credit. Banks are being forced to de-risk at the same time there is a supply demand imbalance in the demand for credit relative to the supply of credit available. The US economy is in solid shape, and inflation is likely to stay above target over the next five years due to shortages in labor and housing, along with higher costs associated with climate change and deglobalization. Higher nominal growth is a tailwind to borrowers and helps them keep current on loans. The benefit to lenders is higher yield and fewer problem loans to work out.

Private credit markets are likely to continue to take market share from the banking sector and even public capital markets. At Capital Creek, we have been able to identify high-quality private credit managers who we believe can continue to produce 12%-to-15% total returns with excellent downside protection. We believe we are in the third or fourth inning of ***The Golden Age of Credit*** and are working hard to make sure our clients participate and reap the benefits.