Asset Class Investment Strategies

Private Debt

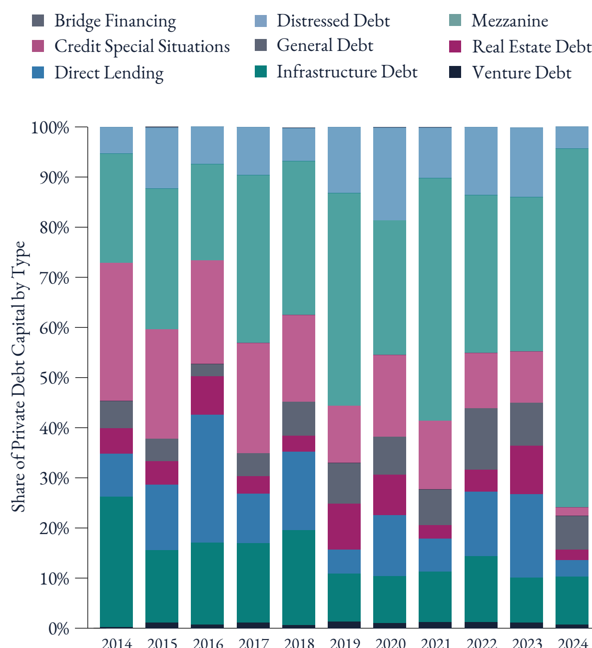
Major Trends

Private Debt continues to offer attractive returns at a premium to public markets, driven by lower liquidity, the smaller average size of private borrowers, and the greater flexibility afforded to borrowers by a single or smaller group of lenders. However, we believe investors should seek to diversify portfolios away from more commoditized, upper middle-market direct lending in favour of sub-sectors with a more attractive supply of, and demand for, capital such as non-sponsored lending, asset-backed lending, and capital solutions. We maintain a long-term positive view on the opportunity set in Private Debt, viewing alternative lenders as an increasingly important component of the financing ecosystem, with a clear secular trend towards further disintermediation of the banks in the financing of corporate borrowers, financial, and physical assets. We believe that a multi-strategy portfolio of complementary exposures in Private Debt should offer a resilient source of long-term income. In the near term, higher-for-longer interest rates and robust operating performance for corporate borrowers are expected to support attractive risk-adjusted returns from the asset class. However, as the asset class matures, we are carefully monitoring areas of the market where an oversupply of capital and resulting competitive pressures may lead to a change in risk profile and the quality of returns generated.

Fundraising remains below the peak of 2021, with assets raised accruing disproportionately to senior direct lending strategies and to funds with total assets above $5B. Despite increased interest in Private Debt strategies from a range of new investors, total assets raised in 2024 will be broadly in line with the $226B raised in 2023 and roughly ~20% below the 2021 peak.[1] As of Q3 2024 direct lending strategies accounted for 71% of total funds raised (Exhibit 1), and large-cap funds (over $5B in total assets) were 50% of assets raised (Exhibit 2). Funds over $1B in AUM accounted for 87% of assets. This trend reflects the further institutionalisation and broader adoption of the asset class as well as the attractive risk-adjusted returns that have been available in this period of higher rates. However, it also illustrates the requirement for managers to be able to compete for sourcing in the largest parts of the market.

Exhibit 1

Direct lending strategies accounted for 71% of assets raised in Private Debt by Q3 2024

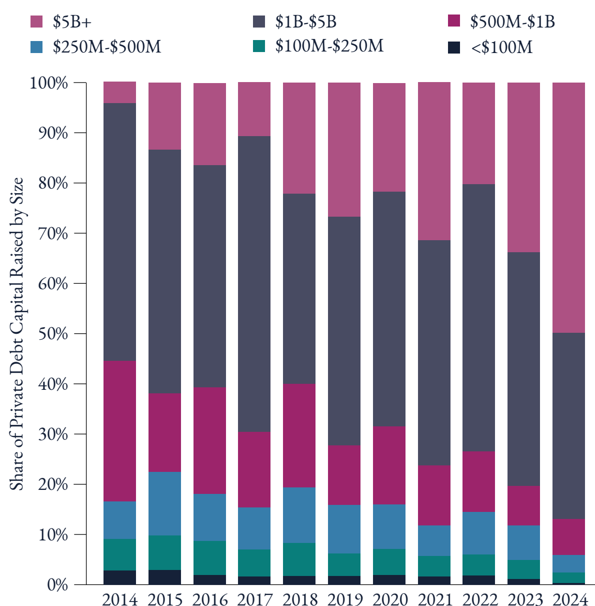


Source: Pitchbook; Geography: Global; As of 30 Sep 2024

1 Pitchbook Q3 2023 Global Private Market Fundraising Report

Exhibit 2

Funds greater than $1B in AUM received 87% of the capital raised by Q3 2024



Source: Pitchbook; Geography: Global; As of September 30, 2024

The broad investor focus on senior lending and large-scale managers has left specialists, complex strategies, and smaller managers capital constrained. First-time funds only accounted for $2.2B of capital raised by Q3 2024, as compared with $14.8B for the full year in 2021. The dearth of funding presents an opportunity to partner with managers in specialist and emerging strategies where investors can still be well compensated for risk assumed. This aligns with our strategy of focussing on areas of the market where we believe a specialist focus confers a material advantage. Partnering with earlier stage managers also makes it possible to obtain attractive fee terms, to have input into vehicle structuring and risk profile, as well as offering enhanced access to co-investment capacity. We value specialist managers who are not forced to compete on terms, and who are not compelled to deploy significant capital into areas of the market where terms and credit protection may be at risk of erosion by competitive dynamics.

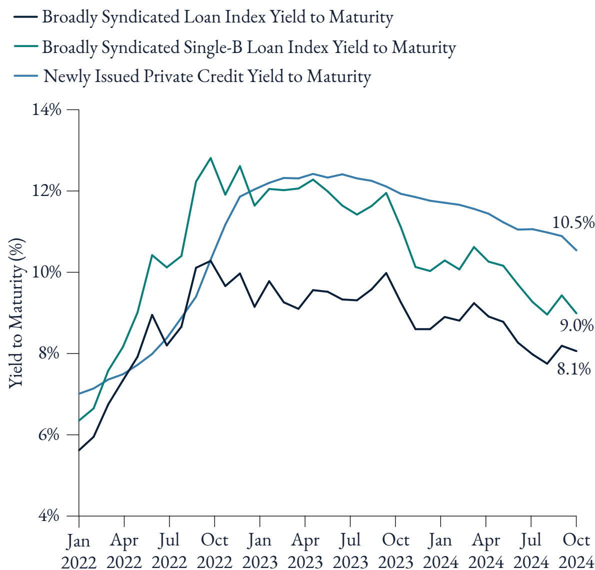
In large-cap and upper-middle-market corporate direct lending we believe the conditions for an *'age of dispersion'* in asset- and fund-level performance are in place. Higher returns from senior direct lending driven by higher interest rates and a scarcity of capital in 2022 led some market participants to declare a '*golden age*' of private credit, leading to a slew of capital raising and new entrants into the market which we highlighted in Insights 2024. While new issue private credit continues to offer a >200bps premium to public loans, and ~150bps in premium to lower-rated (single-B) public loans (see Exhibit 3), we have seen material spread compression in large cap and upper-middle market lending, as well as a deterioration in the strength and number of covenants, and in the quality of loan documentation. While this partly reflects the fact that these are larger cap issuers who may benefit from more stable operating profiles and higher equity valuations, we believe competitive pressures driven by excess capital flows into direct lending strategies is one factor in the weakening of the risk/return profile. Deals where issuers have the option of choosing between financing in the public loan markets and a private financing are those where we see the tightest spreads and the weakest terms, as the revival in public loan issuance in 2024 offers a cheaper alternative generally subject to fewer covenants, putting further downward pressure on pricing and terms in private credit.

We expect this dynamic, combined with the legacy of aggressive lending which took place in 2021 at similar spreads but at higher levels of leverage, to lead to a higher dispersion in outcomes than we have previously seen. We continue to believe that direct lending should remain a core component of a Private Debt allocation, but where previously there was little differentiation between fund returns, we believe that manager selection will be key to maintaining high quality risk-adjusted returns in future.

Private Debt
continued

Exhibit 3

New issue private credit continues to offer a premium to public loans

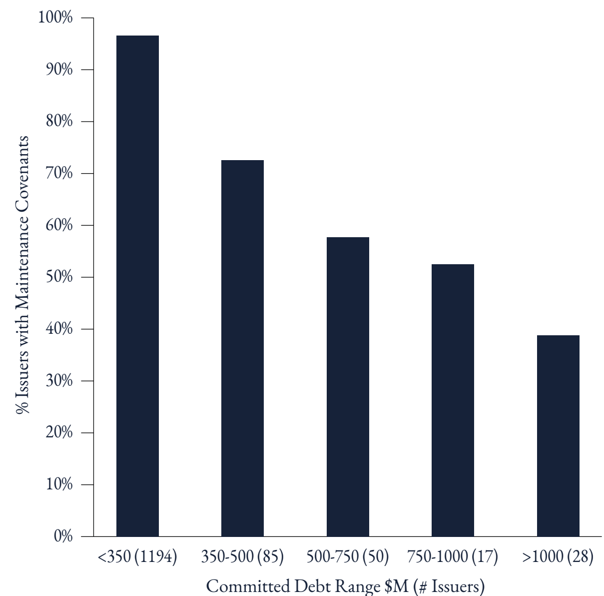


Note: J.P. Morgan Leveraged Loan Indices are designed to mirror the investable universe of USD institutional leveraged loans, including US and international borrowers. Yield to Maturity includes Original Issue Discount.
Source: JP Morgan Market (public loan Indices), KBRA Private Credit Index

In corporate lending our preference is to focus on less well-trafficked areas of the market, on opportunistic credit, and on sector specialists providing an alternative to dilutive equity financing. We view lower middle-market lending and non-sponsored lending (i.e. where the equity owner is not a private equity firm) as offering the potential to lend at higher spreads with lower leverage. While smaller companies may be more susceptible to challenges during periods of economic weakness, they typically have lower leverage, tighter covenant packages and the lender is more likely to control the deal, enabling them to work directly with the borrower to mitigate any issues early. Smaller loans tend to attract better covenant packages (see Exhibit 4), with nearly 100% of issuers borrowing <$350M having maintenance covenants in comparison to roughly 50% or less for those borrowing $750M+ in a single issue. Accordingly, we believe that despite the underlying companies being higher risk, lower leverage and tighter structuring more than compensates, resulting in enhanced risk-adjusted returns.

Exhibit 4

Maintenance covenants become less prevalent as deal sizes grow



Source: Morgan Stanley, S&P

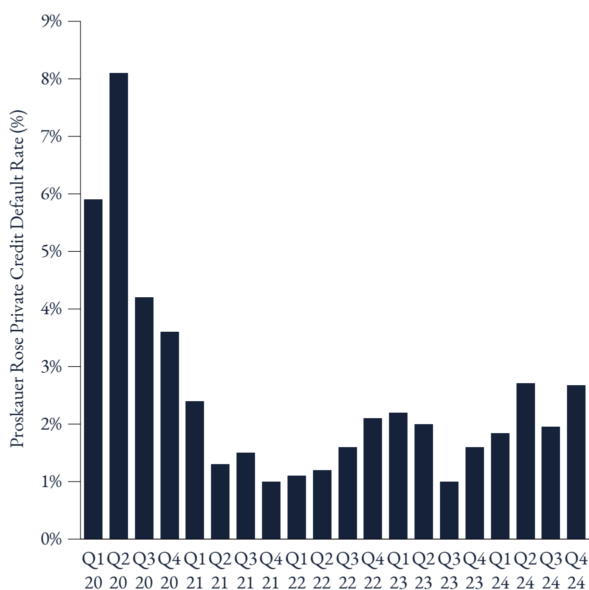
We continue to see opportunities in sector specialist lending, with software, life sciences, legal, and agricultural lending among the sectors we have in our portfolio and pipeline. We favour sectors with clear long-term secular growth and where specialist underwriting confers a competitive advantage. With M&A and IPO volumes still at relatively muted levels, the appetite for non-dilutive financing (i.e. non-equity) at low LTVs (loan-to-value) remains high amongst founders creating the opportunity to obtain attractive contractual debt returns with attached equity upside.

Reported default rates and credit losses remain lower than in the public markets (see Exhibit 5). However, there is anecdotal evidence of a wave of 'silent defaults'. The reported use of loan amendments, injections of capital from sponsors, and extensions of existing debt to mitigate pressure on more marginal borrowers and reduce the risk of default is rising. This is one of the key attractions of the asset class. Historically, private lenders have been able to control credit losses due to the bilateral nature of the loans which confers a high level of control over outcomes during periods of stress, as

well as tighter covenants than in public markets. While this remains the case for a large proportion of loans, we believe that default rates are likely to increase at the margin. An extended period of higher interest rates is likely to increase the need for restructurings and creative financing solutions for over-levered borrowers, particularly those whose current debt financing was arranged prior to the increase in base interest rates in 2022. This presents an opportunity for capital solutions managers who can provide flexible financing to idiosyncratic situations and benefit from contractual returns on newly issued senior debt. We are increasingly seeing the opportunity for lenders to structure private solutions to both private and public companies, substantially increasing the addressable market for these types of managers.

Exhibit 5

The Proskauer Rose Private Credit Default Index remains muted through Q3 2024

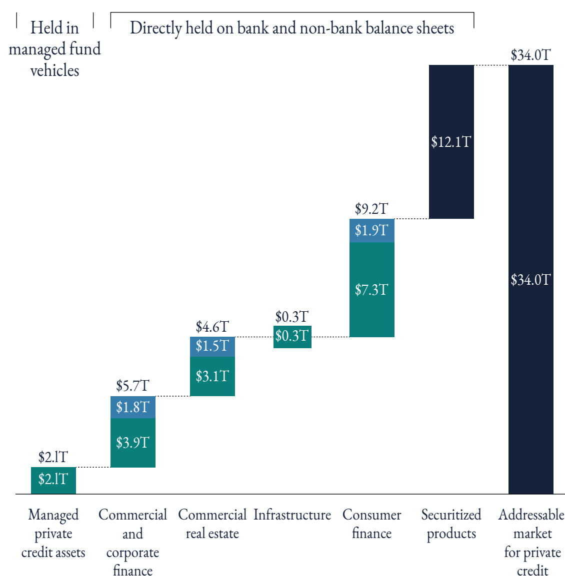


Source: Proskauer Rose

Outside corporate lending, there is secular opportunity developing in asset-backed finance which could see a material transfer of assets from banks to non-bank institutions over the next 10 years. Asset-backed finance is lending secured by cash-flowing contracts with predictable cash flows, such as leases, mortgages, receivables and licenses. These assets have historically been financed by banks who are now retreating from the market due to regulatory requirements, risk aversion and a reduction in balance sheet capacity. McKinsey estimates the overall size of the addressable market for private credit at over $30T (see Exhibit 6) of which $5-6T could shift to non-bank lenders in the next 10 years. The assets most likely to move are those in asset-backed finance, mortgages, consumer lending, infrastructure, and direct real estate lending. We believe the size of the opportunity could mirror the direct lending opportunity which arose following the GFC, and that scale players in asset-backed finance will be the first beneficiaries. although we also see opportunities for smaller players to finance the middle market. The breadth of the collateral pools available offers the opportunity to invest in highly diversified, income-generating assets which complement exposures in corporate lending. Our pipeline includes a range of potential investments in both physical- and financial-asset backed strategies, including equipment finance, portfolio finance and, selectively, consumer lending.

Exhibit 6

The potential addressable market for private lenders includes a broad range of asset-backed strategies



Source: McKinsey

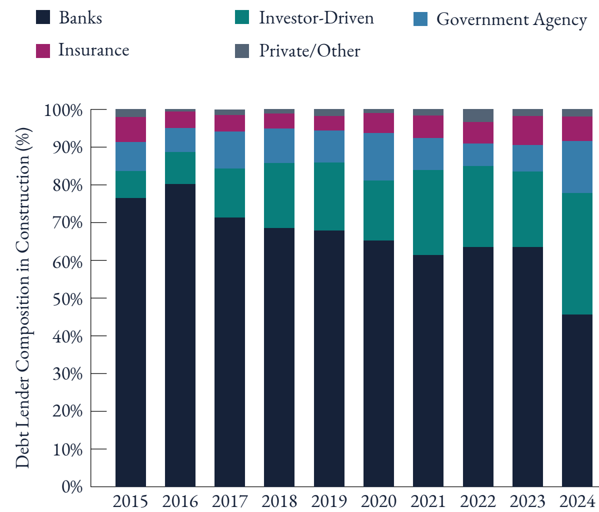
Asset Class Investment Strategies

Private Debt
continued

The need for debt financing in commercial real estate remains persistent amid a material reduction in riskier real estate lending activity by bank lenders. While there continues to be stress in real estate credit with delinquencies continuing to rise, albeit slowly, there is evidence that the US real estate cycle has troughed with some non-bank lenders beginning to return to the market and increased CMBS issuance. However, the regional banks which traditionally provided debt financing for real estate, and particularly construction, have tightened their lending standards, reduced the leverage they are prepared to extend and increased their pricing. This has resulted in much lower participation, particularly in construction lending (see Exhibit 7).

Exhibit 7

The participation of banks in construction lending declined meaningfully in 2024

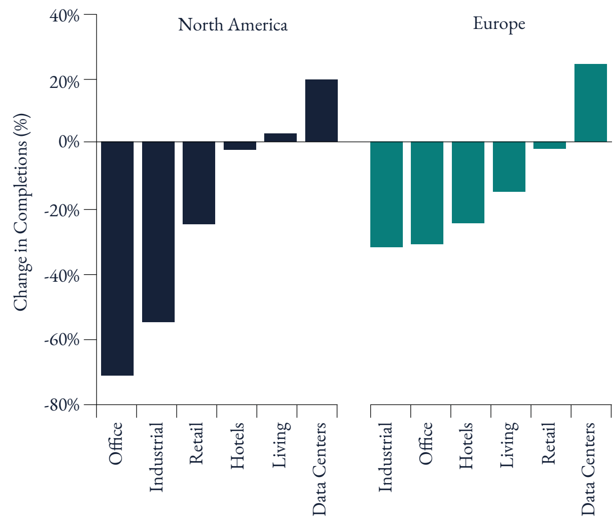


Source: MSCI Real Analytics

There has been a reduction in new supply in most property types driven by high financing costs, construction costs which have risen faster than inflation, and rents which have not kept pace. Exhibit 8 shows the decline in expected completions in 2025 in comparison to the 2021-2024 peak, where only data centres are expected to have increased compared to prior peak levels. These dynamics create a need for financing, not only in the recapitalisations of challenged structures, but also in the funding of new developments, redevelopment, rehabilitation, and change of use to meet what is likely to be a gap in supply across a range of sectors. Managers who can be opportunistic and provide capital solutions for idiosyncratic projects stand to benefit most.

Exhibit 8

Change in Expected 2025 Completions from 2021 Peak



Source: JLL Research

Golden Rules

1. Pursue a multi-strategy approach: a diversified portfolio of complementary risk exposures in Private Debt should offer a resilient source of long-term income and mitigate the risk of weakening risk adjusted returns in more commoditised areas of the market.
2. Target specialists in niche strategies: specialist providers of capital offer certainty of execution to borrowers, and can command a premium due to lower levels of competition and higher degrees of complexity.
3. Focus on downside protection: identify and partner with disciplined investors who i) take senior positions in the capital structure, ii) lend at low LTV ratios, and iii) maintain discipline on covenants and documentation. Identify investors that can protect capital and have the necessary skillset to directly manage assets in the event of a restructuring.
4. Generate outperformance through customisation and direct investment: seek structures which offer enhanced discretion, tax benefits, fee savings, and customised risk exposures. Partner on co-investments to benefit from more immediate deployment, lower fees and greater transparency.
5. Allocate selectively to uncorrelated strategies: these strategies can offer attractive diversification benefits and resilience in a market downturn. Given their esoteric nature, they can pose a unique diligence challenge, and it is critical to be aligned with best-in-class managers.

Sub-Strategy Attractiveness

Capital Solutions and Corporate Special Situations: Favourable view. A longer-than-expected period of higher interest rates is likely to drive a greater need for restructurings and transformational capital.

Specialist Lending: Favourable view. Target sector specialists in strategies that requires expert underwriting (e.g., life sciences, energy transition, agriculture, emerging technology) where a lower availability and attractiveness of equity financing are creating opportunities to offer non-dilutive financing with embedded equity upside.

Real Estate Lending: Favourable view. Persistently higher interest rates continue to put pressure on equity valuations and available capital remains constrained. This creates attractive opportunities for senior and mezzanine lending specialists with proven sourcing advantages and the ability to manage and restructure assets where necessary. Focus on more opportunistic transactions in an uncertain market environment.

Asset-Based Lending: Favourable view. Asset-based lending strategies are benefitting from a structural change in banks' appetite to lend in many areas, improving pricing and the available opportunity set. Asset based lending can provide an attractive yield base to a Private Debt portfolio.

Portfolio Finance: Selectively positive view. Increased capital raising and interest from large lenders have compromised the attractiveness of pricing in more mainstream transactions. Favour managers with a clear sourcing and structuring advantage.

Private Debt
continued

Large-Cap and Upper-Middle-Market Direct Lending: More negative view. While direct lending should represent a core holding for investors in private credit our overall favourable view of the strategy is tempered by new entrants affecting pricing and terms in the upper-middle market. This makes the strategy less attractive than smaller-cap, non-sponsor, and specialist strategies which may be more able to maintain pricing discipline. Continue to avoid commoditised strategies with limited credit protection and higher leverage. Favour lenders who maintain a controlling stake in their transactions.

Mezzanine and Junior Capital: More negative view. The proliferation of unitranche and stretch senior deals makes mezzanine and junior capital only selectively attractive at this point in the cycle and in the current spread environment. Consider an allocation on evidence that a default cycle is nearing a peak in order to capture upside benefits from a lower valuation environment.

Distressed for Control: Negative view. Dislike long and legally-intensive bankruptcy and recovery processes which culminate in full equity ownership and which can carry a high opportunity cost as compared with capital solutions and special situations strategies. Participate selectively where managers have a defined edge and market conditions are particularly favourable.

2025 Strategic Priorities

- **Diversify corporate direct lending exposures:** Upper-middle-market direct lending is becoming increasingly commoditised, and we see more attractive risk-adjusted returns in less well trafficked areas of the market. Seek exposures in lower-middle-market, non-sponsor and sector specialist lending, as well as capital solutions to obtain higher spreads and better downside protection.
- **Build asset-backed and real estate allocations:** Take advantage of long-term secular trends as the banks withdraw from hard- and financial-asset-backed strategies. Allocate to opportunistic real estate to take advantage of recapitalisations, rehabilitation and redevelopment. Add exposure to asset-backed securities to benefit from rapidly-amortising cash-flowing assets.
- **Position for dispersion with allocations to opportunistic credit and capital solutions:** Higher-for-longer interest rates and the legacy of aggressive lending in 2020-2021 are likely to drive an increase in restructurings. Allocate to capital solutions to benefit from potential recapitalisation and rescue lending opportunities and to opportunistic credit managers who are able to lean into dislocations created by geopolitical volatility. Consider a broad-based distressed allocation.

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Private Investment Fund Risk

Investors should be aware that investments in private investment funds involve a high degree of risk. Investors could lose the entire amount of their investment or recover only a small portion of their investment if the fund suffers substantial losses. The principal risk factors associated with an investment include the following. Please refer to Private Placement Memorandums of funds for full disclosure of risk factors:

Market & Economic Risk – Changes in factors like interest rates, inflation, monetary policy, economic growth, investor sentiment, time horizons and exogenous events (like terrorism or pandemic) can undermine the investment strategy temporarily or for a long period.

Currency Risk – Investors will be subject to currency market risks associated with fluctuations in the value of the foreign currencies in which their investments are denominated. Dramatic fluctuations could have an adverse impact on the profitability of the client account.

Availability of Investment Opportunities – Identification of investment opportunities involves a high degree of uncertainty and is based on a subjective decision making process and there is a risk that opportunities will not achieve targeted rates of return.

Counterparty Risk – Investor's assets may be exposed to the credit risk of the counterparties with which, or the dealers, brokers and exchanges through which, Partners Capital deals, whether in exchange-traded or off-exchange transactions.

Limited Operating History – Certain private funds have no operating or performance history for investors to consider and there is no guarantee the fund's investment strategy will be successful.

Limited Diversification – Private funds are not limited in the amount of capital that may be invested in one industry, sector, geography or similar category of asset class. Non diversification would increase the risk of loss if there was a decline in the market value of any security or category of asset class in which a private fund has invested a large percentage of their assets.

Limited Liquidity Risk – Many investments are not readily liquid, and may lock up capital for several years. Investors may be unable to dispose of investments at the most advantageous time because of limited withdrawal rights, which could result in significant loss of capital.

Limited Regulatory Oversight – Private companies are not likely to be Regulated Investment Companies. Investors may not be provided various protections offered to more regulated or registered funds.

Management Fraud – Investment managers can commit fraud It is our job to try and avoid those that appear to have the potential to commit fraud or otherwise misappropriate client funds but it is not always ascertainable from any amount of due diligence.

Operational and Organisational Risk – All asset managers bring some risk that they will fail to execute their investment strategies effectively. Past performance is not indicative of future results.

Multiple Level of Fees Risk – Paying excessive fees is a significant risk in any asset class. Investment management fees and performance fees are sometimes charged by both Partners Capital and the Manager used. Investors might bear multiple levels of fees.

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Private Investment Fund Risk
continued

Valuation Risk – Valuation of the securities and other investments may involve uncertainties or judgmental decisions. Independent pricing information may not always be available.

Side Letters – Private funds may enter into agreements ("Side Letters") with certain prospective or existing investors, under which those investors receive advantages.

Hedging Transactions – While the use of hedging techniques can reduce the risks associated with particular investments, the transactions themselves entail risks. If there is an imperfect correlation between a hedging instrument position and a portfolio position that is intended to be protected, the desired protection may not be obtained, and result in greater risk of loss.

Derivatives – Risks include but are not limited to: changes in the market value of securities held, and of derivatives relating to those securities, might not correlate perfectly; the market to sell a derivative could be illiquid; certain derivatives magnify the extent of losses incurred; and derivatives traded over the counter are subject to counterparty credit risk.

Small Capitalisation Stocks – Securities of small capitalisation/financially distressed companies tend to be more volatile than the securities of larger and more stable companies. The securities of such companies are generally less liquid.

High Yield Securities – Funds may invest in high yield bonds that are more risky than investment grade bonds. Yields and prices of high yield securities may be more volatile. Lower rated securities may include securities that have the lowest rating or are in default, so involve risks in addition to those associated with higher-yield securities (i.e. high degree of credit risk).

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