DunPort
CAPITAL MANAGEMENT

Broadly Syndicated Loans (BSL) versus Private Credit

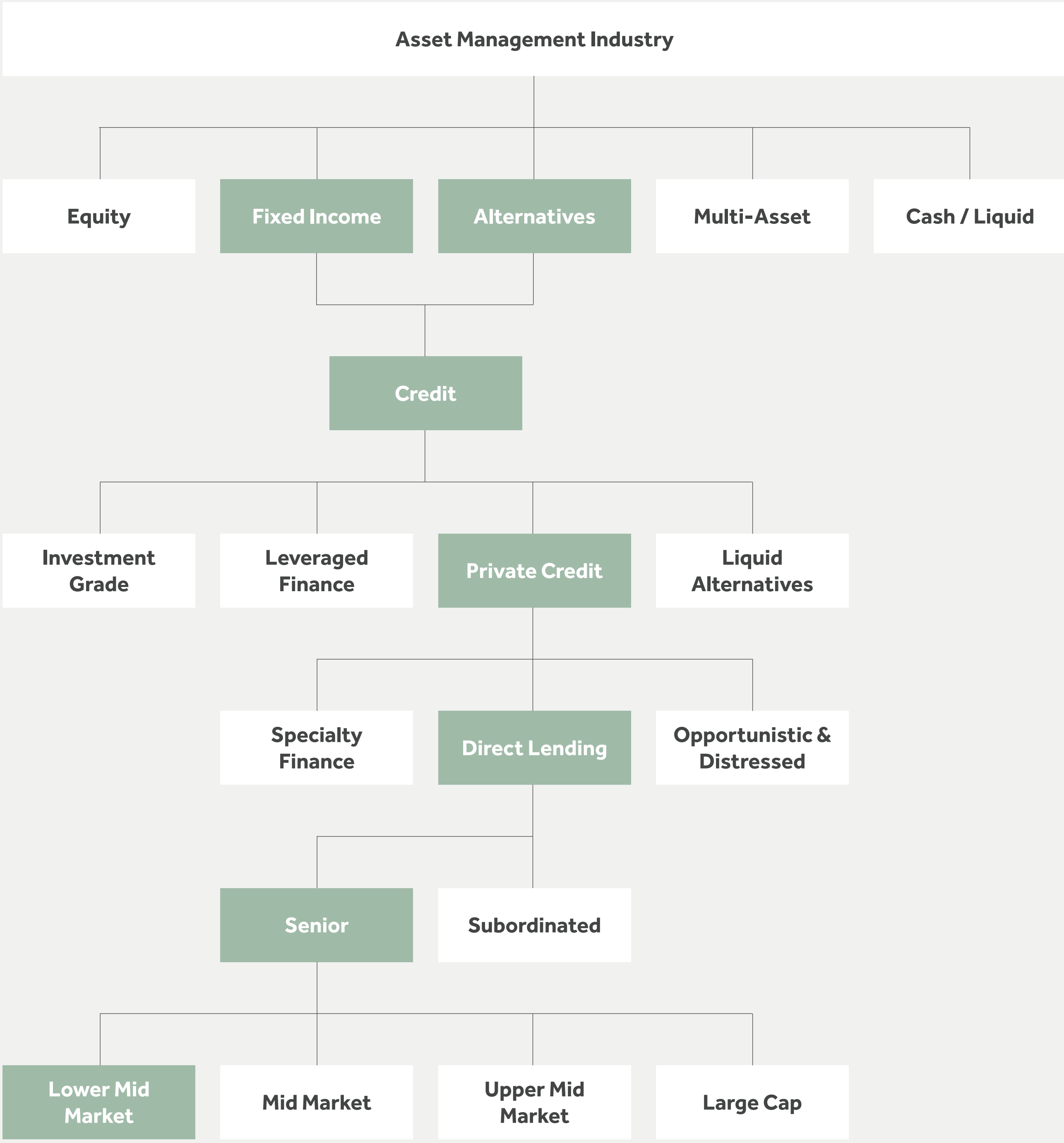
June 2024

The Credit Landscape Overview

The Credit Landscape

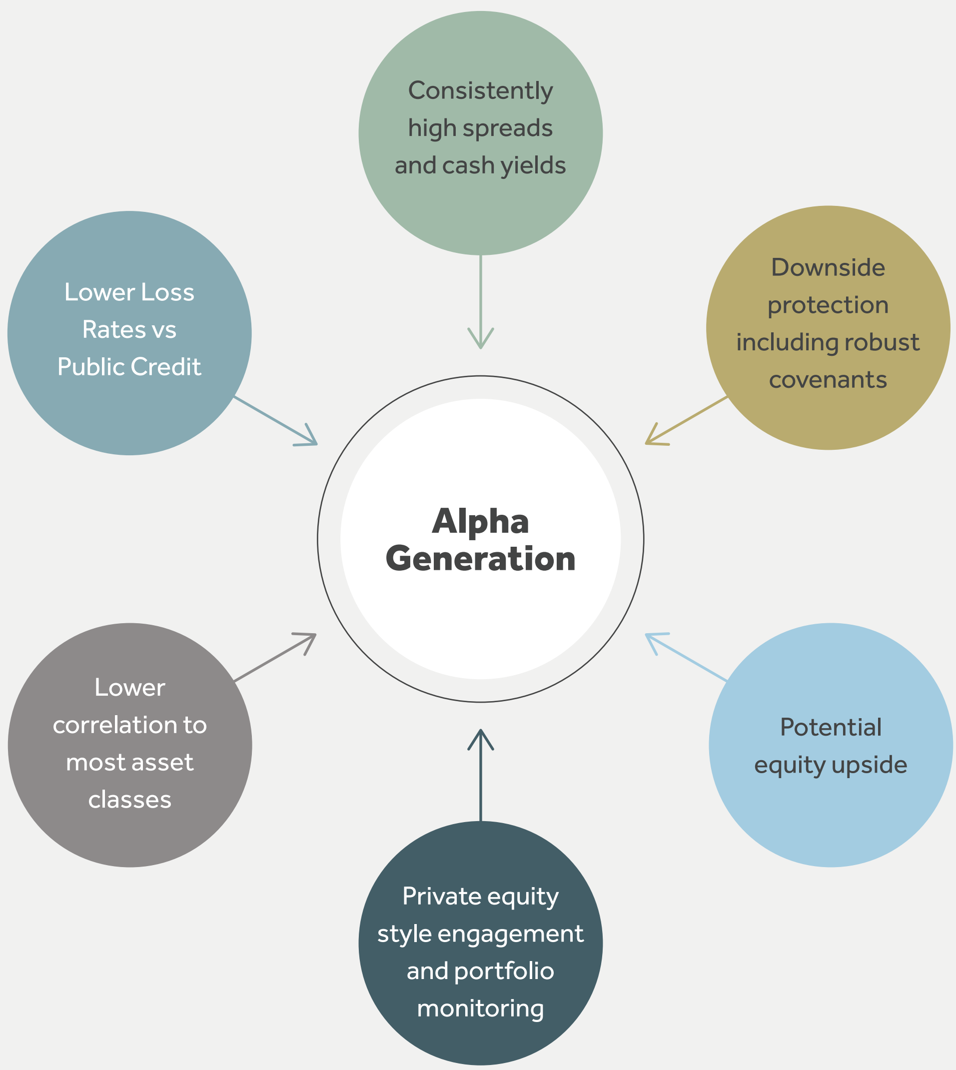
Traditional Credit		Alternative Credit	
Investment Grade	**Leveraged Finance**	**Liquid Alternatives**	**Private Credit**
Instruments that typically have a credit rating of AAA to BBB- (S&P). Corporate has strong capacity to meet financial commitments - Investment Grade Corporate Bonds	Instruments that typically have a credit rating of below BBB-. Part of a more highly levered capital structure - High Yield Bonds and Broadly Syndicated Bank Loans	Credit funds & strategies that have moderate liquidity; strategy specific - Hedge Funds, Mutual Funds, BDCs	Credit funds and strategies that have high degree of illiquidity and tend to earn an illiquidity premium - Direct Lending, Opportunistic & Distressed Credit, Specialty Finance

DunPort's position in the Asset Management Industry



Executive Summary

- Investments in broadly syndicated loans ("BSLs") as well as high yield loans provide a form of beta or systematic risk exposure for investors to the general sub investment grade fixed income market.
- Such investments provide an investor with diversified and liquid (but not necessarily in times of market dislocation) exposure to the sub investment grade fixed income market, but with associated increased price volatility given the publicly traded nature of such assets.
- Private credit, and specifically speciality parts of the private credit market, provide an investor with a form of alpha exposure to the sub investment grade fixed income market.
- Liquidity is not a feature of this part of the fixed income market, but nor is price volatility and over the medium to long term the asset class has demonstrated its ability to outperform other similar asset classes and consistently deliver low duration yield and preservation of capital.



Broadly Syndicated Loans versus Private Credit

Cambridge Associates[1] believe that an allocation to direct lending is more attractive than the BSL market due to better terms, better pricing, and less mark-to-market volatility. Putting aside the size of the underlying borrowers (which, in direct lending, has historically been €75m or less in EBITDA), there are several key differences between direct lending and BSLs ,according to Cambridge Associates.

One difference is the underlying documentation that governs the relationship between lender and borrower. Private loans tend to include more protections for investors, while BSLs will typically have no financial maintenance covenants (so called "cov-lite") and often lack important structural protections, such as allowing [the incurrence of additional indebtedness and] the movement of collateral to unrestricted subsidiaries. Another important difference is liquidity. Private loans are mainly accessible via private closed-end structures that oblige investors to tie up capital for a defined period. Meanwhile, exposure to BSLs can be obtained via exchange-traded funds, mutual funds, and separately managed accounts. To compensate for this illiquidity risk, private loans historically have offered spreads that are 125 bps to 200 bps higher than BSLs.

Direct Lending ("DL") strategies vary, with key areas of differentiation among managers including transaction size and whether they focus on sponsored or non-sponsored borrowers. Cambridge Associates believe that there is a place in portfolios for different strategies, but universally we favour experienced teams that have sufficient scale to manage a well-diversified portfolio and have resources to work out problem loans. If an investor plans to commit to just one DL manager, we favour one with a differentiated strategy and would try to avoid more commoditized areas of the market, such as sponsor-backed middle market lending. More compelling alternatives include those managers that focus on non-sponsored, lower-middle market, or borrowers that are outside of the plain vanilla leveraged buyout that is the most competitive part of the market.

Generally, managers focused on the upper middle market are competing against the BSL market and may be most likely to sacrifice lender protections. At the moment, the limited number of managers in that space is helping maintain some discipline, but more entrants may force some to succumb to borrower demands for flexibility. Managers that focus on the less-trafficked lower-middle market are working with borrowers that have fewer sources of capital, even where sponsors are involved. Thus, they are more likely to agree to lender-friendly terms and pricing. Direct lenders that focus on non-sponsored borrowers will typically need a strong origination network to find opportunities with companies that do not have the assistance of the capital markets teams employed by large private equity sponsors, which typically can extract the best terms.

1 Investors Should Direct Their Attention to Private Lending - Cambridge Associates

Broadly Syndicated Loans versus Private Credit

Direct lending should be considered one element of a well-diversified private credit portfolio that may also include strategies like credit opportunities and specialty finance. Direct lending will provide stability and a ballast to the portfolio. In comparison, credit opportunities strategies typically should provide a higher return, though with more potential volatility. We favour credit opportunities strategies with the ability to pivot to distressed if the opportunity should develop. Specialty finance strategies should provide some diversification from corporate risk and ballast, given their focus on lending to or owning pools of assets. Specialty finance strategies can range from lending against a pool of consumer or small and medium enterprise loans, to more complex strategies such as litigation finance or insurance.

For investors that do not already have private credit buckets, an allocation to direct lending could occupy a number of places in a portfolio. Some investors include direct lending and other private credit strategies in illiquid or private equity buckets for purposes such as income and J-curve mitigation. However, the current market environment means some investors are overweight privates and thus unable to allocate to new strategies. Instead, investors have turned to diversifier buckets to make private credit allocations. However, the current market environment means some investors have overweight "private debt allocations" and thus unable to allocate to new strategies. Instead, investors have turned to "diversified" buckets to make private credit allocations.

DunPort Views

Over the medium to long term, and in particular with curated exposure to specialist niches within private credit, the difference in spreads can be higher. We would also note that spread represents only one side of the risk / reward equation. A far better measure of relative value amongst fixed income assets is the spread per turn of leverage ("SPTL") or coupon per turn of leverage ("CPTL") metrics. These metrics allow investors consider what reward (spread / coupon) they are receiving relative to the risk they are taking on in an underlying loan. SPTL and CPTL have historically been materially higher in Private [debt] loans relative to the BSL market. At DunPort we target SPTL of greater than 150bps and more typically in excess of 200bps. Taking into account current base rates, we would target CPTL on most transactions in excess of 300bps. Pitchbook in an April 2023 article noted that the BSL was offering historically high returns relative to risk summarised in the following excerpt:

"Let's consider lender compensation, relative to risk, as measured by spread-per-unit of first-lien leverage (SPL). The first-lien debt-to-EBITDA ratio has declined significantly so far this year, to 3.8x, from 4.3x in 2022, although lenders' share of overall financing remained relatively unchanged, at 80% of total debt. At the same time, spreads also stepped back slightly on an annual basis, to Sofr+415, from Sofr+427. As a result, lenders received 110 bps per unit of first-lien leverage so far in 2023, an eight-year high, up from 100 bps last year and 88 bps in 2021. This does indicate a unique opportunity within BSL during 2023, but this is not only an outlier in long term trends but also still well below the relative return (per unit of risk) available from Private Debt"

https://pitchbook.com/news/articles/with-lbos-scarce-leverage-in-syndicated-us-loan-market-sinks-to-7-year-low

The Case For Private Credit[2]

iCapital, in an August 2023 article titled "Direct Lending: An Attractive Alternative to Fixed Income", set out a number of features of private debt that make it relatively more attractive than public sub investment grade debt. Below follows some extracts from that article:

Exhibit: Public vs. Private Credit Structures

	Public			Private
	Investment Grade	**High Yield**	**Broadly Syndicated Loans (BSL)**	**Direct Lending**
Borrower Size	Mega	Large	Large	Typically, Middle Market
Default Risk	Low	High	Medium	Typically, Low to Medium
Interest Rate Risk	Medium/High (Fixed Rate)	Medium/High (Fixed Rate)	Low (Floating Rate)	Low (Floating Rate)
Due Diligence	Limited	Limited	Limited	Extensive
Covenants	Strong	Weak	Weak	Strong
Monitoring Rights	Weak	Weak	Limited	Strong

Source: iCapital. For Illustrative purposes only

2 Direct Lending: An Attractive Alternative To Fixed Income - iCapital

1. Downside Protection

The market demand for financing creates an attractive environment for direct lenders, allowing private credit managers to be more selective.

Experienced and disciplined private credit managers are typically able to achieve strong downside protection because the privately negotiated nature of their transactions permits them to conduct extensive due diligence on potential borrowers and to secure covenants. This process allows a lender to better assess the credit quality of a company by more thoroughly evaluating critical factors such as its cash flow profile, quality of revenue, competitive positioning within its industry, and the strength of its management team. This diligence process is extensive and can take several weeks, providing the lender with greater access and control over terms and structure.

Many private credit managers have been able to take advantage of their due diligence findings and their direct negotiating position by including covenants into their loan agreements. These covenants are conditions imposed by the lender to help protect against potential downside. Loan covenants can be affirmative (positive), which requires a borrower to fulfill a specific obligation; restrictive (negative), which is intended to prevent a borrower from taking a specific action without the lender's approval; or financial, which requires the borrower to maintain specified financial performance on an ongoing basis (maintenance covenant) or ensure certain thresholds are met if an action is taken, for example, issuing debt (incurrence covenant). These covenants, in addition to proactive monitoring of a borrower's financial performance, allow lenders to identify potential issues early on and to work with management teams to address those issues before they hinder the company's ability to pay off its interest and debt obligations.

In addition, most direct lenders invest in senior secured and unitranche debt (which combines a company's first and second lien debt into a single security). These lenders are therefore positioned at the top of the capital structure and have a priority claim against a company's assets in the event of a default.

The public market for non-investment grade corporate debt also represents a markedly different risk-return profile. While direct lending in Europe can be segregated into three broad categories: lower mid market (EBITDA less than €10m), mid market (EBITDA €10-50m) and upper mid market (EBITDA greater than €50m), broadly syndicated loans (BSL) are generally made available to larger companies with greater than €75m in EBITDA. Banks originate these loans and then distribute to mutual funds and collateralized loan obligations (CLOs) for a fee, rarely maintaining the underlying loan on their balance sheet due to capital reserve requirements. Therefore, rather than conducting due diligence on the fundamental credit quality of the borrower, banks are incentivized to focus on the quantity they are able to sell in the liquid BSL market. In contrast to direct, BSL buyers typically only have a week or two to conduct due diligence and rely on materials provided by the borrower's underwriter.

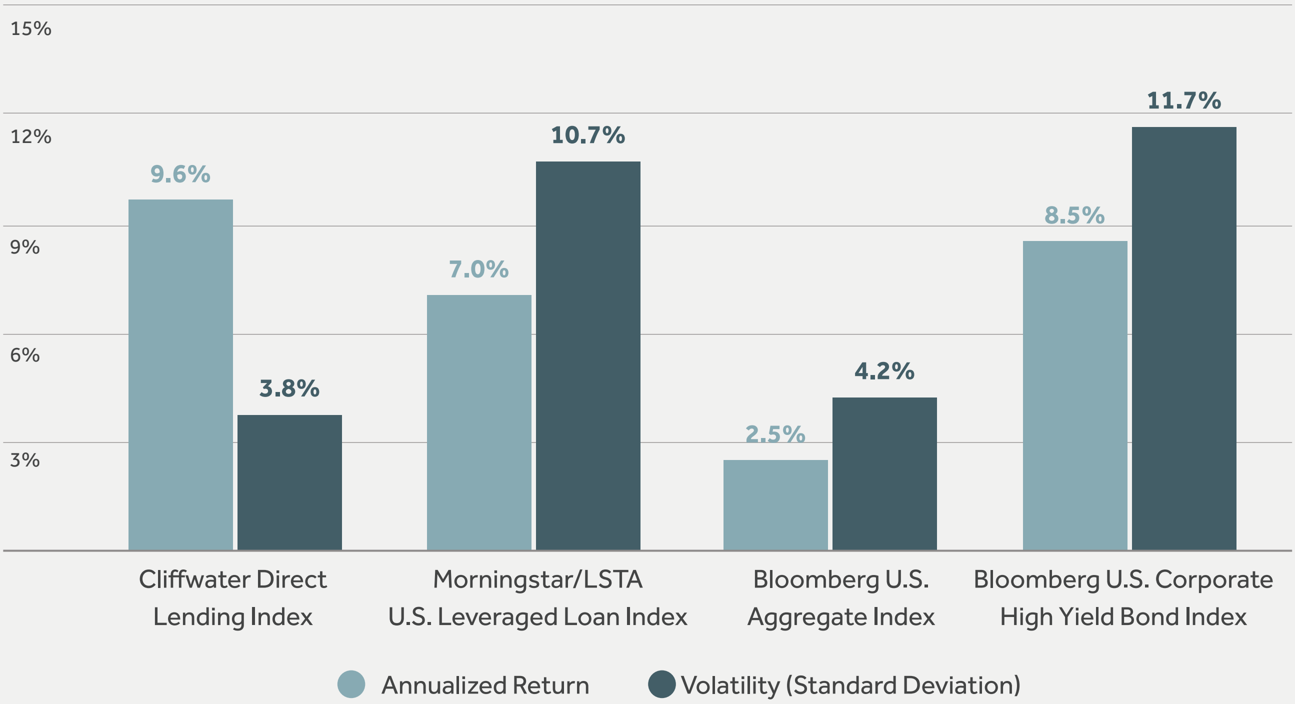
Moreover, the BSL market is relatively liquid with larger pools of capital. This market efficiency has generally led to loan terms favouring the borrower, with fewer protections for the lender in the form of financial covenants. Investors in BSL are often "term takers" — meaning they have little ability to negotiate terms or covenants. In fact, the vast majority of BSLs are covenant-lite, meaning they do not include maintenance covenants that are embedded in direct lending agreements. While BSLs are senior in the capital structure, the lack of protective covenants have contributed to higher default rates and lower recovery rates versus direct lending to middle market companies, where lenders are able to respond to deteriorating conditions before bankruptcy is required.

2. Enhanced Yield – Illiquidity Premium

Private credit has generated higher yields than most other fixed income strategies, including public high yield and broadly syndicated loans. Naturally, investors demand a premium over more liquid fixed income investments to justify the inability to trade private credit.

As shown in the Exhibit below, private credit has outperformed leveraged loans by 260 bps and high yield by 110 bps over the past 15 years. Moreover, private credit experienced significantly less volatility over this time frame. Notably, the past 18 months has seen a shift from a low interest rate environment to the Fed's rate hiking cycle beginning in March of 2022, demonstrating the benefit of direct lending's floating reference rate.

Exhibit: Private Credit vs. Public Credit Risk Return Profile
Annualized returns and volatility based on trailing 15-year quarterly data (Q1 2008 – Q1 2023)

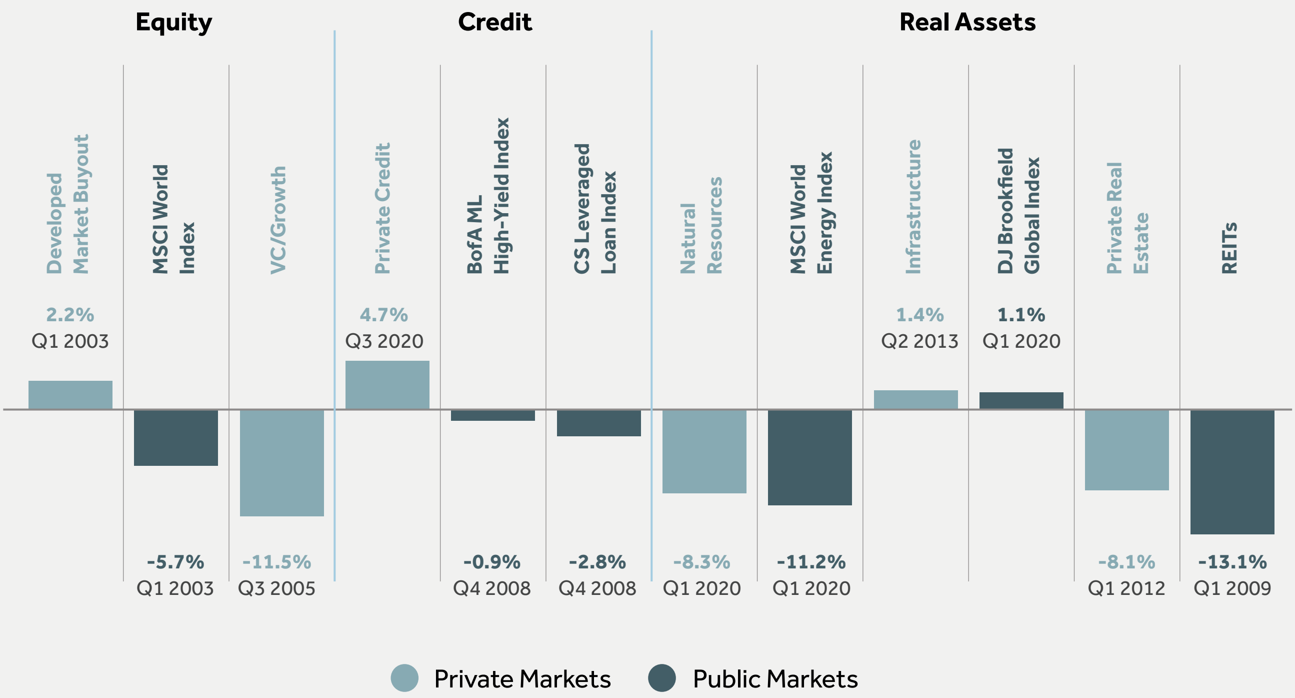


Source: Bloomberg, iCapital Investment Strategy, as of 15 August 2023. Note: return data is high through March 31, 2023.
For illustrative purposes only. Past performance is not indicative of future results. Future results are not guaranteed.

2. Enhanced Yield – Illiquidity Premium

While private credit's floating rate structure generally insulates lenders from duration risk, rising interest rates and high inflation environments can prove challenging to their portfolio companies, which face potentially slowing or even contracting growth and reduced cash flow as economic activity softens, potentially leading to higher defaults. However, historical data suggests that private credit downside protections and access to greater lender information may help mitigate this risk. In analysing the lowest five-year annualized performance by asset class over the past 25+ years, it can be shown that private credit generated the best results with a 4.7% positive annualized return during its worst five-year stretch (as shown in the Exhibit below). Only three other asset classes in this analysis conducted by Hamilton Lane delivered positive performance (two of these also being an alternative investment strategy) during their worst five-year period.

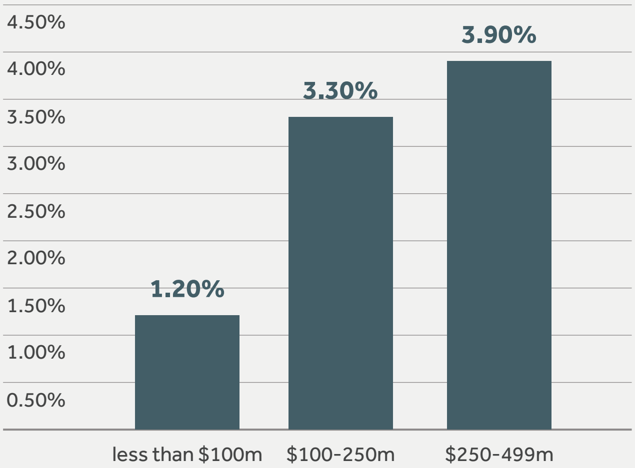
Exhibit: Lowest 5-Year Annualized Performance Across Equity, Credit and Real Assets
1995–2002



Source: Hamilton Lane Data via Colbolt, Bloomberg, as January 2023. Infrastructure from 2006-2022. Natural Resources from 1998-2002. For illustrative purposes only. Past performance is not indicative of future results. Future results are not guaranteed.

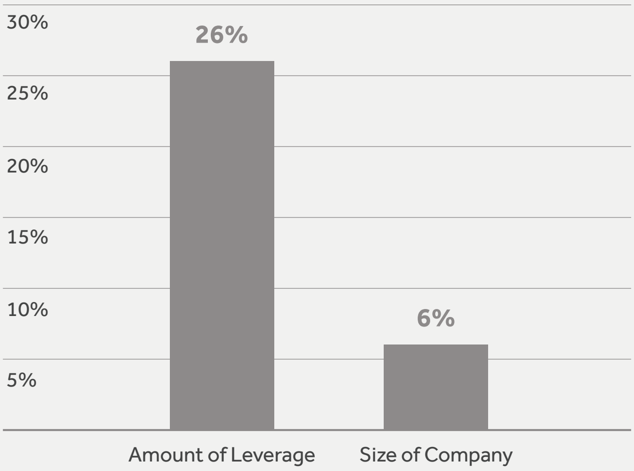
Default and Recovery Rate Data

S&P research from 1995 to 2018 found that smaller loans had nearly a 3x lower default rate than larger loans



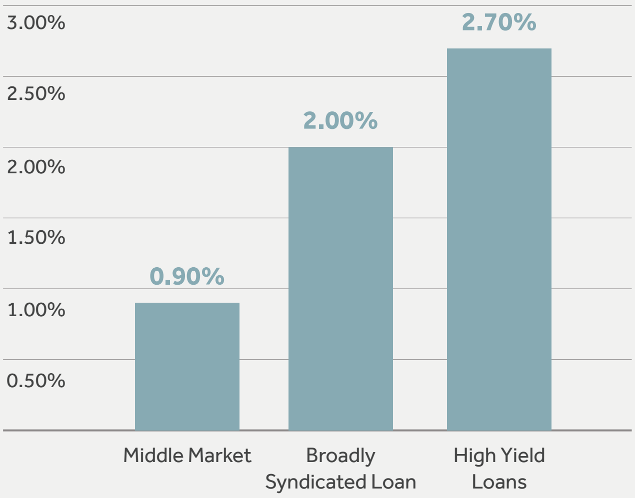
Source: S&P LCD Institutional Loan Default Review; comprises all loans closed between 1995 and Q3 2018. Independent axis labels reflect loan amount ranges

Based on Moody's research, collected over 25 years, leverage is 4x more relevant to default risk than company size



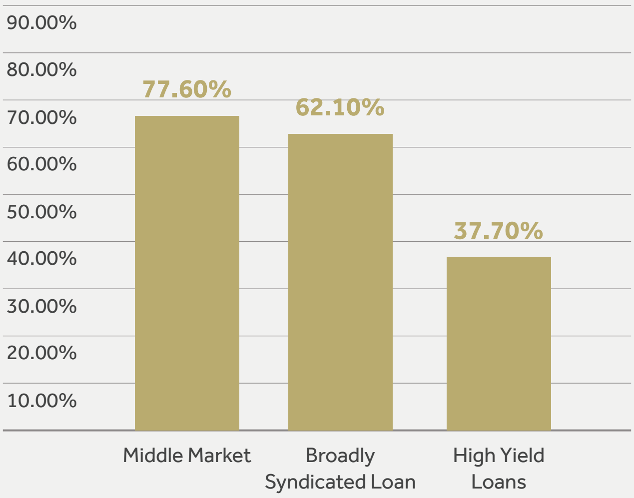
Moody's Analytics, Moody's Analytics RiskCalc 4.0 U.S, April 30, 2012. Based on private firm data, including 110,000 financial statements, 25,000 firms, and 1,600 defaults collected over 25 years. Size of company is measured in total assets

Average Annual Loss Rate Middle market & broadly syndicated loan performance, 1995-1Q 2022



Source: CreditPro/LossStats, an offering of S&P Global Market Intelligence, 1995-1Q 2022; Middle market loans include total facility sizes of less than $500 million and broadly syndicated loans denote total facility sizes of greater than or equal to $500 million

Average Annual Recovery Rate Middle market & broadly syndicated loan performance, 1996-1Q 2002



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