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Opportunities in Private Credit

Current market trends and insights

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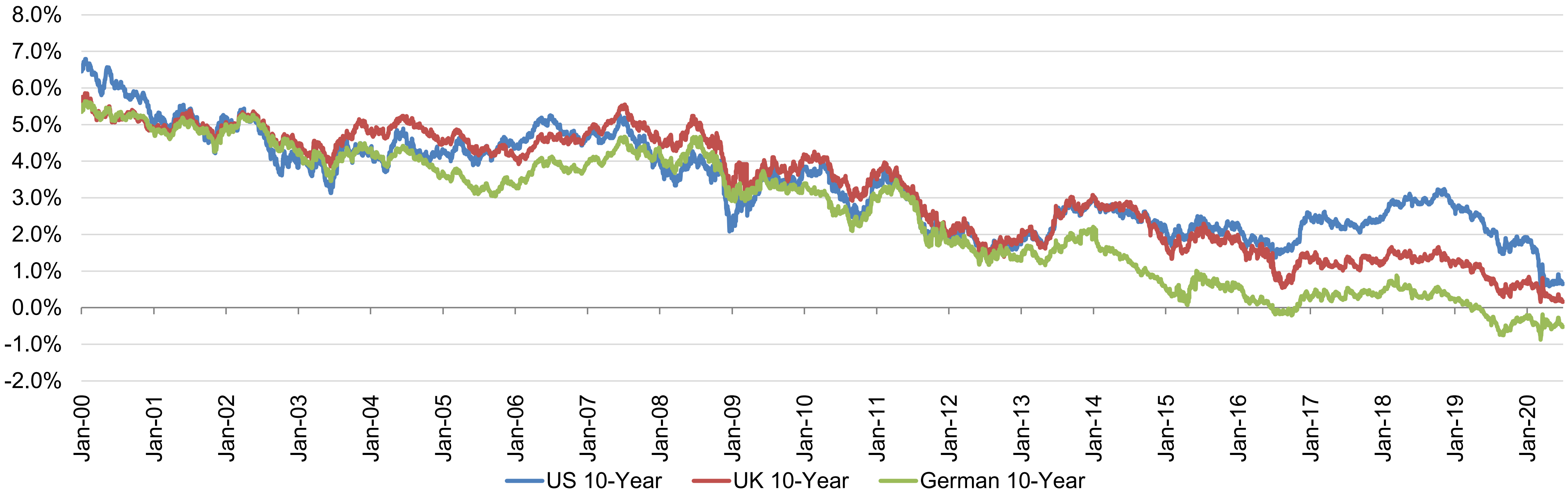
MARKET ENVIRONMENT

Market backdrop

Worldwide interest rates have fallen to historical lows

Government Debt – US, UK and German 10 year bonds



Source: Capital IQ, Schroders, 2020.

The case for private credit strategy

Private credit has emerged as a viable institutional investment opportunity

Credit market dynamics

- Low absolute yield environment
- Stretching for yield requires increased credit and/or duration risk
- Structural changes in traditional lending market has created opportunity

Investor dynamics

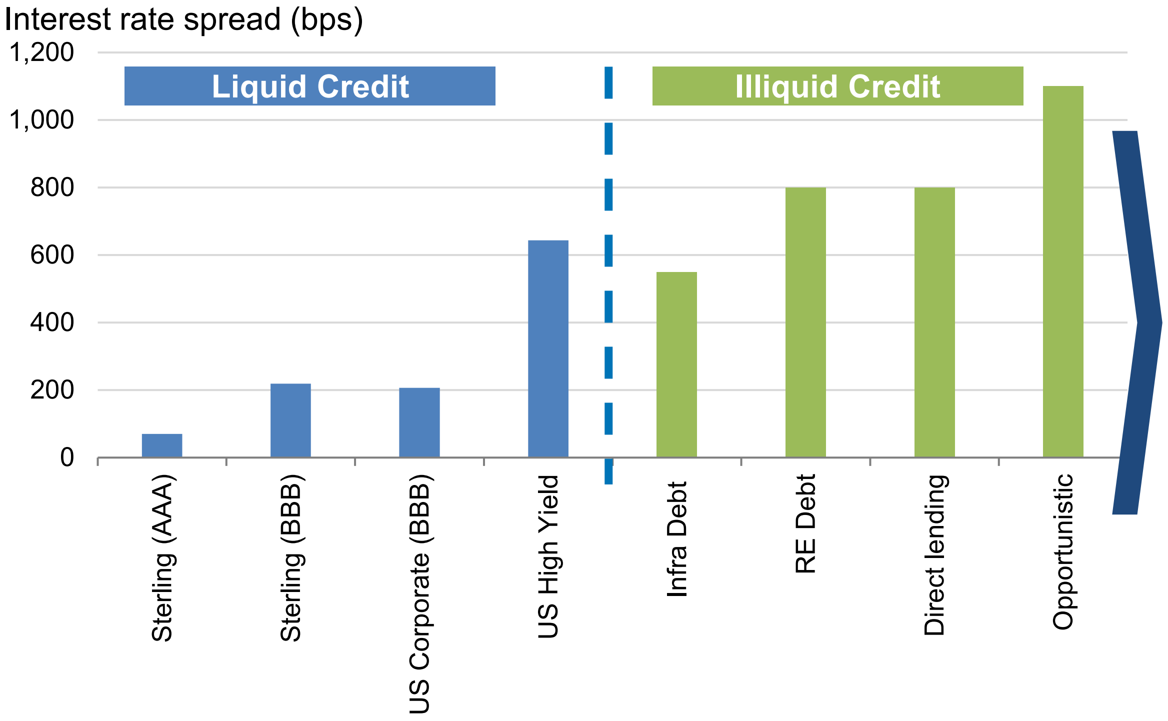
- Difficult to meet long-term income targets from traditional fixed income
- Private debt investing requires additional resources and relationships to execute
- Seeking solution with low-moderate risk profile and high cash yield

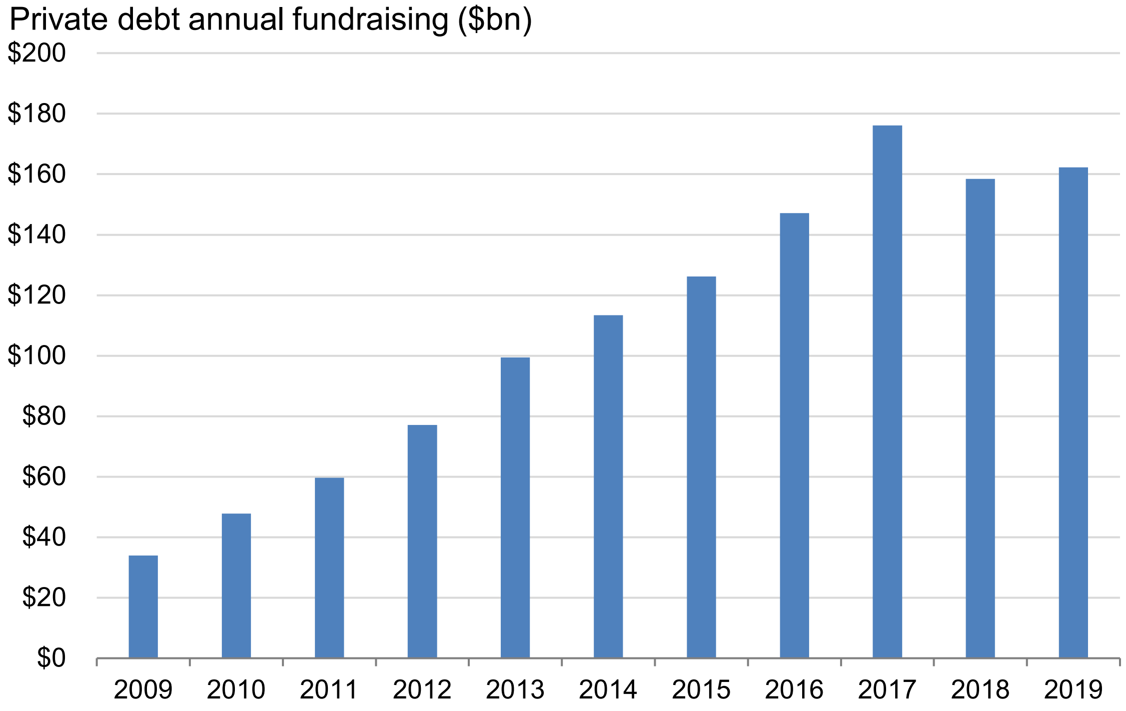
Floating rate investing with a focus on obtaining significant spreads above liquid credit to compensate for taking on illiquidity

Source: Schroders, 2020.

No surprise then that private credit is getting attention

Attractive spreads invites more participation



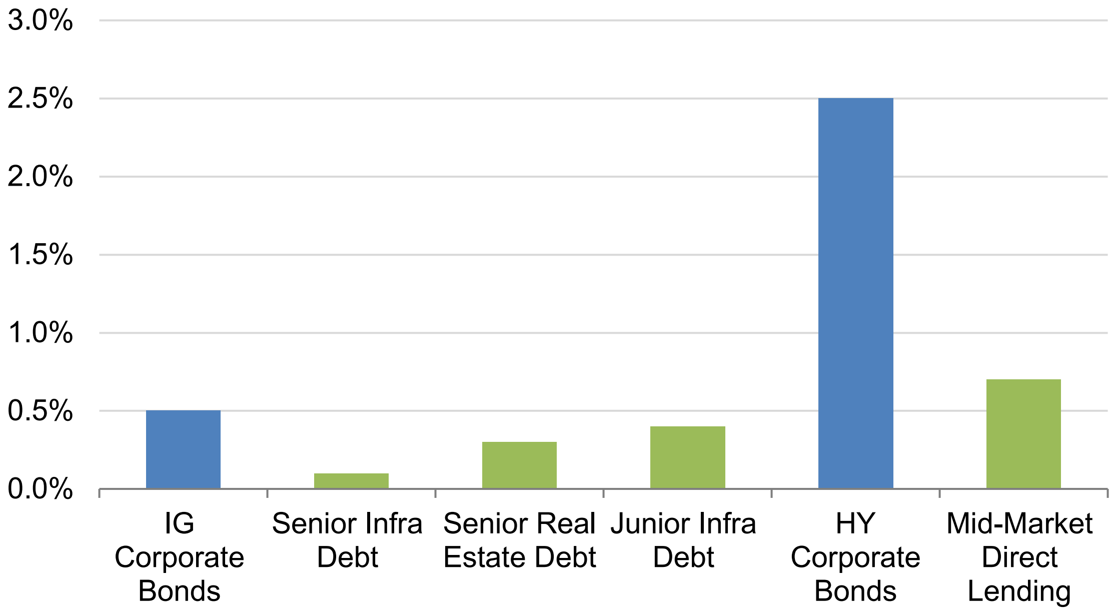


Source: Bloomberg, Preqin, Schroders, 2020.

Note: Private debt market size includes real estate debt, infrastructure debt and private debt per Preqin definitions

Current environment demands protection

Historical loss rates (net of recoveries)



Market backdrop

- Increase in risk-seeking behaviour in recent years
- Market dislocation has caused repricing of risk
- Value the defensive qualities of infrastructure and real estate debt
- Corporate defaults expected to rise but new loan origination now more investor friendly

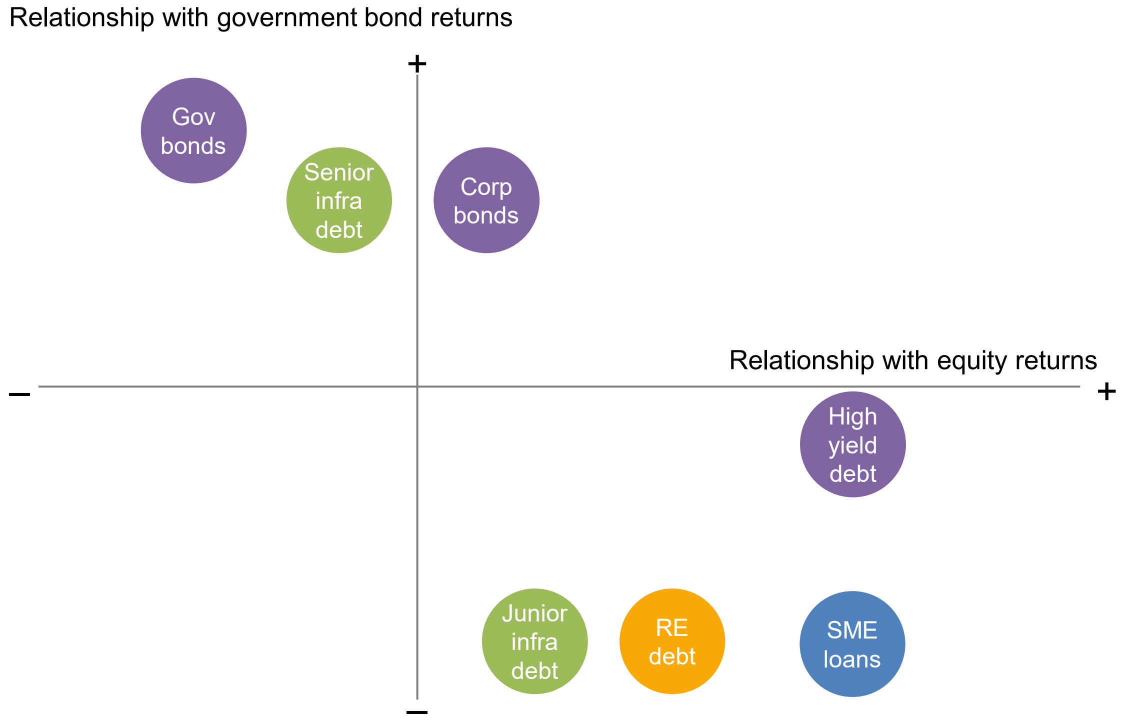
Lower credit losses in private credit

- Combination of lower average default and higher recovery rates

Note: IG and HY corporate bond credit loss rates incorporate default losses (default rates adjusted for recovery rates) and price changes arising from changes in credit quality (net downgrade losses). Figures are shown for illustrative purposes only and may not be reflective of credit spreads or default experience on any individual investment or portfolio. Source: Ares Management Corporation, Bank of America Merrill Lynch, Callan Associates, Cass Business School, CBRE, De Montfort University, Moody's, Preqin, S&P LCD and Schroders, 2020.

Private credit can diversify risk

Illustrative relationships



Estimated correlation vs. other risky credit and equities

June 2008 to December 2019 (in EUR)

	Infrastructure debt	Private Debt	Real Estate debt	High yield	Leveraged loans	Equities
Infrastructure debt	1.0000					
Private debt	0.5591	1.0000				
Real Estate debt	0.6986	0.8463	1.0000			
High yield	0.4308	0.4752	0.2463	1.0000		
Leveraged loans	0.6348	0.8693	0.7985	0.5229	1.0000	
Equities	0.3682	0.6914	0.4124	0.7475	0.6014	1.0000

Source: Schroders. Note: gov = government, corp = corporate, infra = infrastructure, RE = real estate, SME = small and medium-sized enterprises. Indices used for correlation table are as follows: Infrastructure Debt – Investment Grade European Utilities Index. Real Estate Debt – US Commercial Mortgage Backed Securities. Private Debt – Burgiss Private Debt Database. High Yield – Global High Yield. Leveraged Loans – US Leveraged Loans Index. Equities – MSCI ACWI.

Building a private credit program

Key features

Diversification

Governance

Access

Source: Schroders, 2020.

Using breadth to your advantage

Broad universe of options – each with their own pros and cons

Direct Lending

- Cash flow loans in sponsor-backed, middle market assets
- LTV: <60%
- Loan term: 3–4 years
- Geography: US and Europe

Infrastructure Debt

- Operating assets with monopolistic characteristics
- LTV: <70%
- Loan term: 6–8 years
- Geography: Europe

Real Estate Debt

- High quality collateral with low entry basis
- LTV: <75%
- Loan term: 3–5 years
- Geography: US and Europe

Opportunistic Credit

- Niche strategies with limited access
- LTV: Varies
- Loan term: 3–7 years
- Geography: US and Europe

Source: Schroders, 2020.

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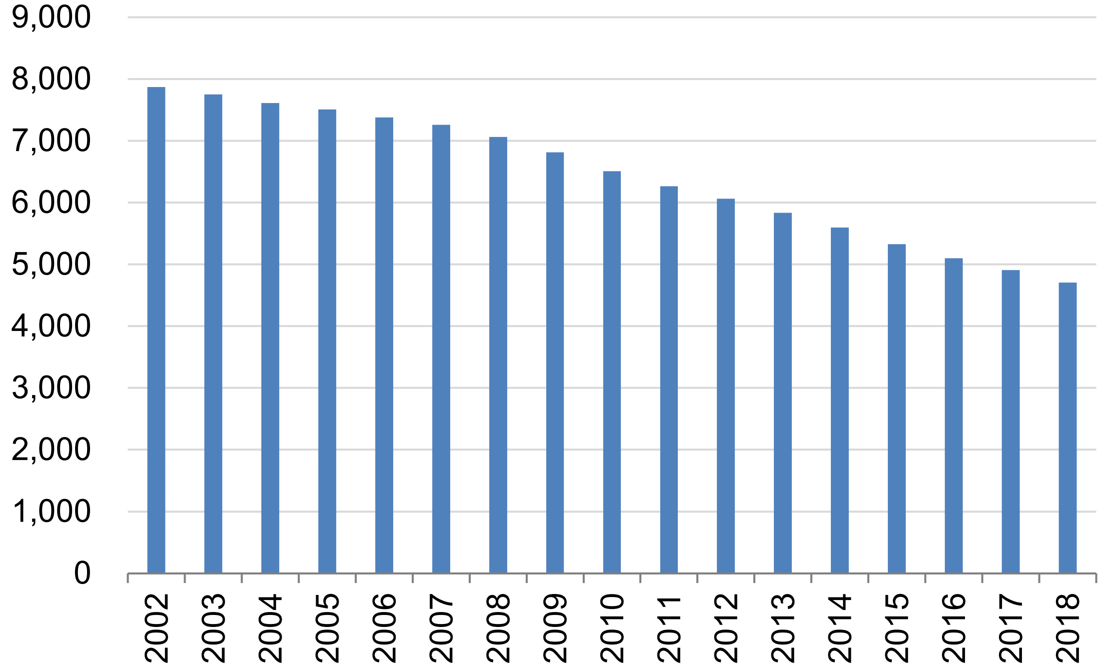
Deep dive

CORPORATE PRIVATE DEBT

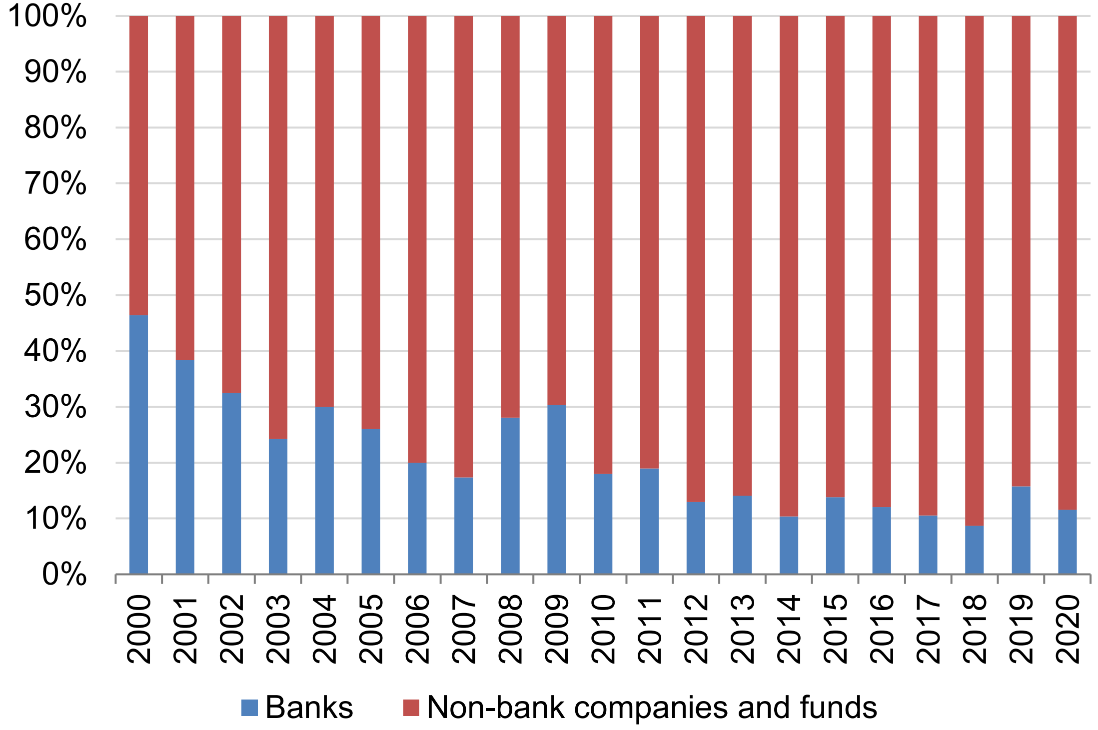
Secular trends underly investment thesis for private debt

US banking industry illustrates fundamentally altered landscape

Total number of US banks



Primary lender market: bank versus non-bank



Source: FDIC, S&P LCD, Schroders, 2020.

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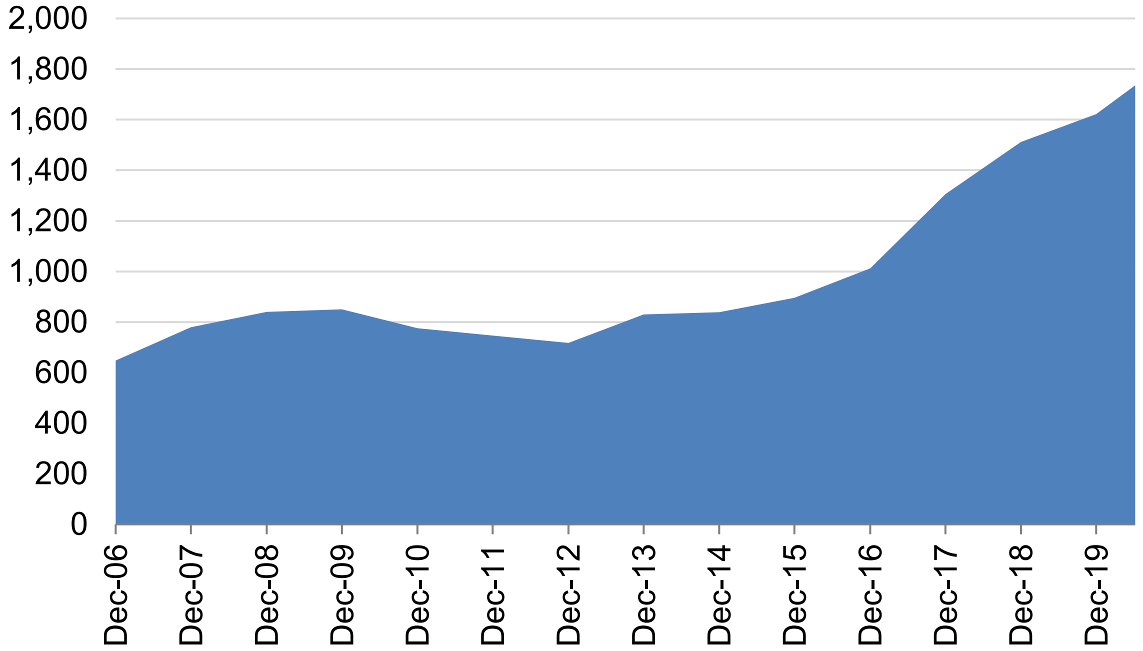
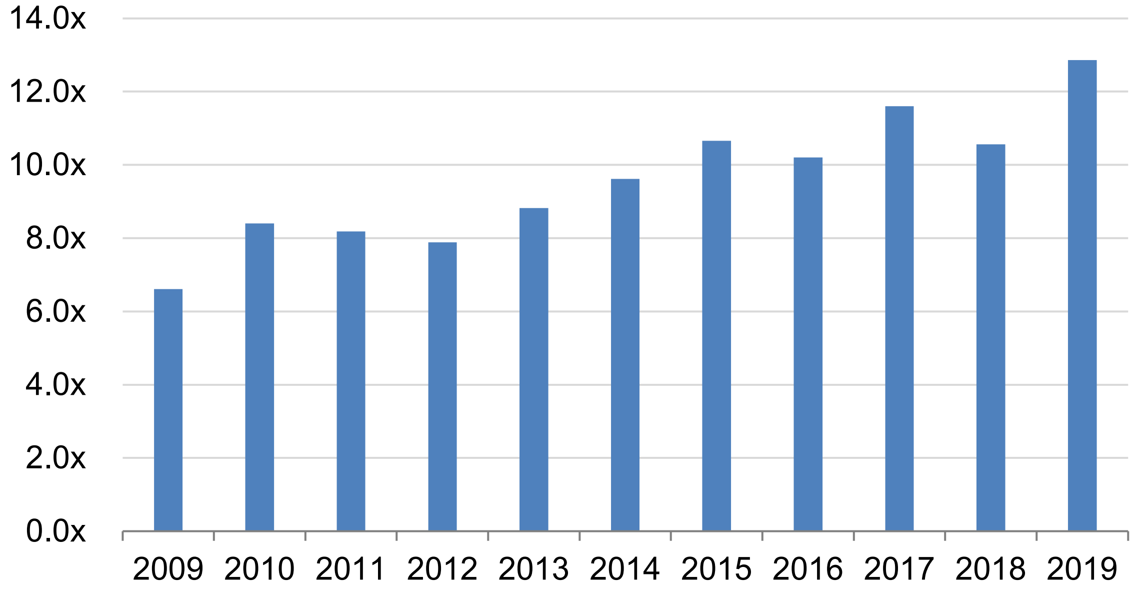
Ample PE dry powder creating need for private debt

Transaction volume driven by increased allocation to asset class

Private equity dry powder (USD bn)



Middle market LBO valuations



Valuations have risen, driving need for increased leverage to drive return in many transactions

Source: S&P LCD, Schroders, 2020.

Where does that leave us?

If you believe in private corporate debt you then have a choice to make…

Source: Adobe Stock, Schroders, 2020.

We choose the middle...the middle market

Middle market represents large, attractive lending opportunity

US: 200k companies
Europe: 56k companies

US: 48 million jobs
Europe: 10 million jobs

US: USD 6tn economic output
Europe: USD 1tn economic output

Source: The National Center for the Middle Market, Schroders 2020.

Middle market loans versus broadly syndicated: Comparison

Middle market loans provide advantages over larger loans

Middle market loan attributes

- Attractive supply and demand dynamics
- Yield premium and more conservative transaction structures
- Lower defaults through recessions and higher recovery rates
- Buy and hold mentality by lenders
- Underlying company performance easier to influence and monitor
- Large opportunity set given size of middle market

Loan comparison

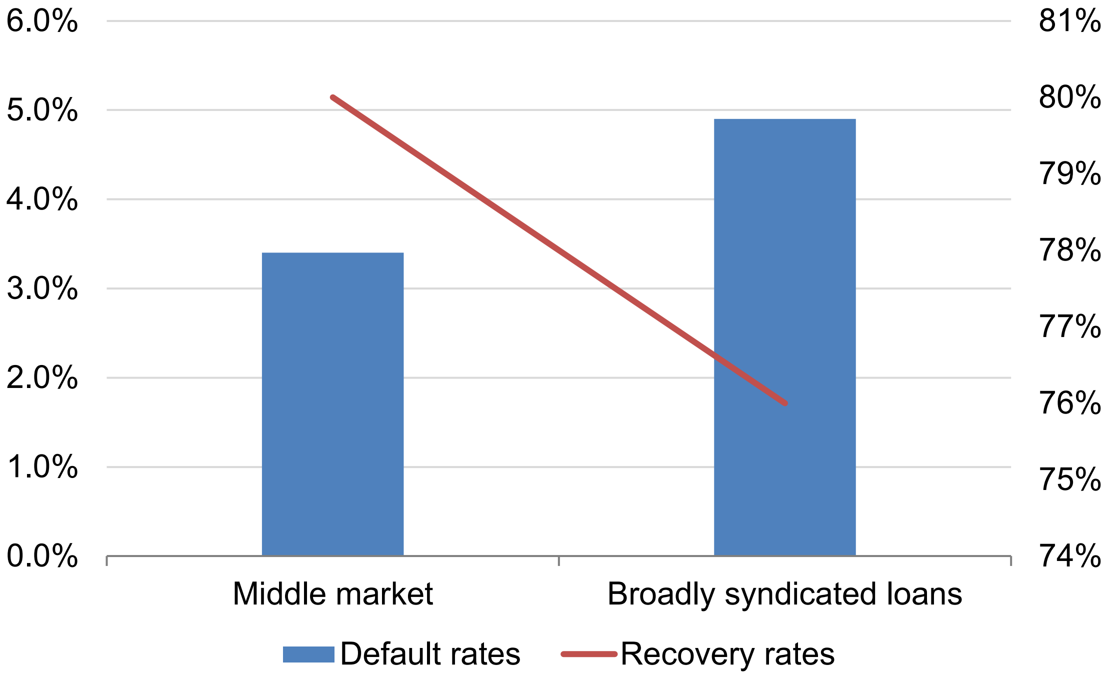
	Middle market	Large buyout
Company Size (EBITDA)	USD 10m to USD 75m	USD 75m +
Covenants	Significant/tight	Limited/loose
Lender model	Originator	Trading desk buyer
Lender influence on structure	High	Limited
Investment process	One month	Less than two weeks
Due diligence	Extensive	Limited
Credit monitoring	High (monthly data, management & GP access)	Limited (quarterly data and public information)
Workout process	Less difficult (simpler structure/fewer parties)	More difficult (various constituents)

Source: SPP Capital Partners, Schroders, 2020.

Middle market private lending offers attractive risk profile

Risk adjusted returns are attractive

Historical performance



Performance attributes

- Lower defaults and higher recovery rates
- Conservative capital structures
- Extensive due diligence by lenders
- Higher influence on company performance

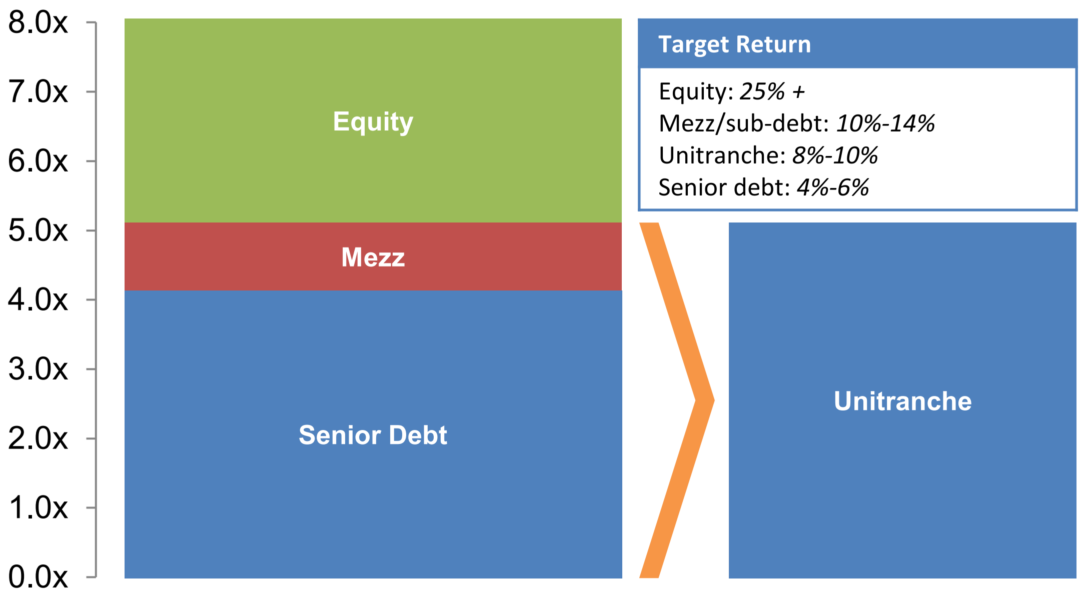
Past performance is not a guide to future performance and may not be repeated.

Source: S&P LCD, Schroders, 2020.

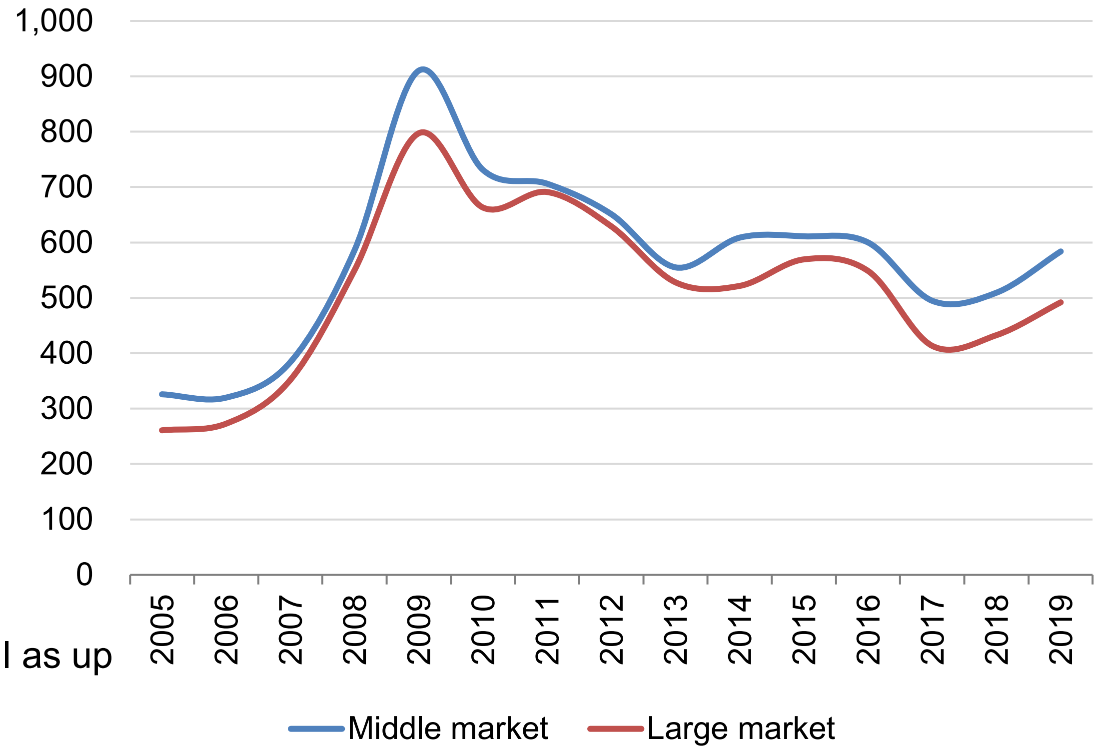
Private lending strategies offer attractive risk-adjusted return

Middle market loans provide higher yield with a simplified capital structure

Sample capital structure



Historical spreads for loans backing LBOs



The value of investments and the income from them may go down as well as up and investors may not get back the amounts originally invested.

Source: S&P LCD, Schroders, 2020.

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Middle market private debt

Asset allocation considerations

Challenges for investors

- Illiquid asset class; not actively traded
- No perfect direct lending index
- Track records vary due to valuations, asset quality, leverage and duration
- Differentiation more nuanced versus other asset classes
- Returns impacted by fund level leverage and fees

Role of middle market lending in portfolio

- Consistent returns with low correlation to traditional asset classes
- Interest rate hedge: floating rate instruments
- Exposure to under-represented asset class
- Downside protection: attractive returns with strong covenants, terms and conditions
- Yield generation
- Return of capital

Source: Schroders, 2020.

Direct lending differentiators

- Position in capital structure
- Size of company
- Sponsor backing

Direct origination

Scale, capital flexibility

Control/active investor

Underwriting and restructuring expertise

Portfolio management

Experience and track record

ESG

Access and transparency

Focus on capital preservation

- Structural protections
- Investment attributes
- Business characteristics

Source: Schroders, 2020.

Summary

Private credit is powerful tool in investor portfolios

Enhanced yield

Downside protection

Diversified portfolios

Source: Schroders, 2020.

Thank you

Important information

- **Marketing material for professional investors or advisers only.**
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