nuveen
A TIAA Company

July 2022

Five considerations for allocating to private credit

Private credit has seen significant inflows for much of the past decade, and recent events have only added to the asset class's attractiveness. But as the name suggests, private credit can only be accessed through deeply established relationships, requiring clients to partner with experienced asset managers that can navigate this market effectively. Five important factors may help investors evaluate the benefits of private credit in a portfolio.

> ***Private credit investments** can help meet the growing demand for **yield, return and diversification.***

HIGHLIGHTS

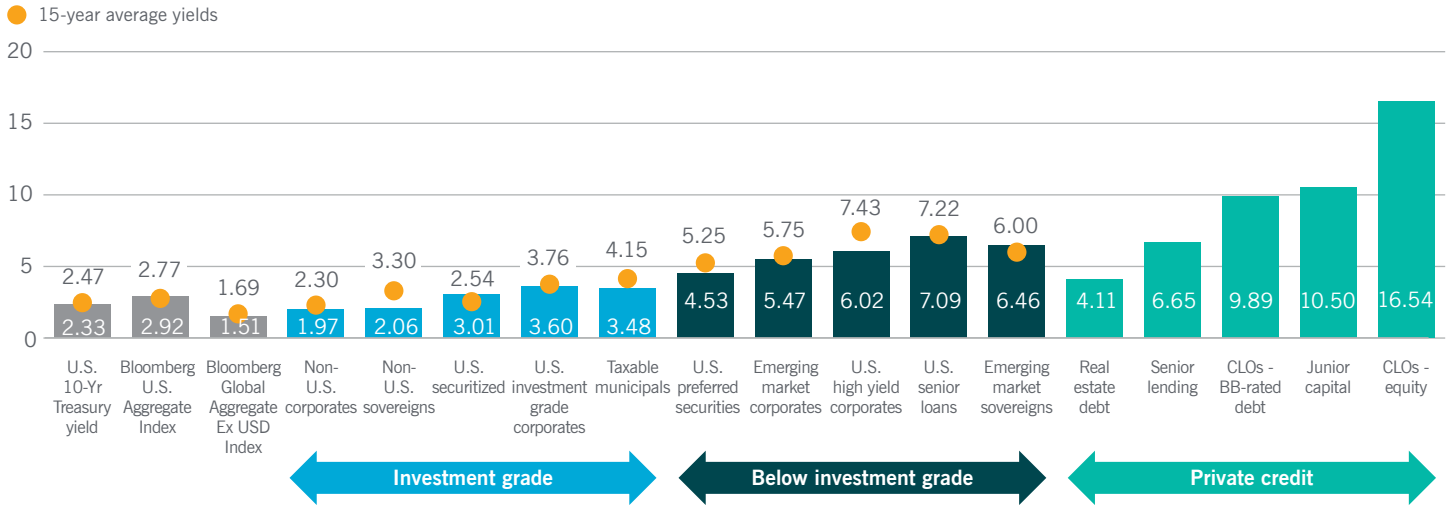
- Creating multiasset portfolios that effectively blend private and public credit has become a top priority for investors seeking to enhance yield and risk-adjusted return.
- Investors' growing interest in private credit has been fueled by rising interest rates and volatility in the public markets.
- Experienced asset managers can better assess the complexity of deal structures and the wide variety of idiosyncratic factors.

INTEREST IN PRIVATE CREDIT IS GROWING

Many factors have driven investors to diversify and expand their fixed income portfolios. Traditional fixed income has offered low rates through much of the past decade. Though rates have been rising, investors are now facing high inflation, volatility and uncertainty.

Figure 1: Fixed income offers opportunities across the credit spectrum

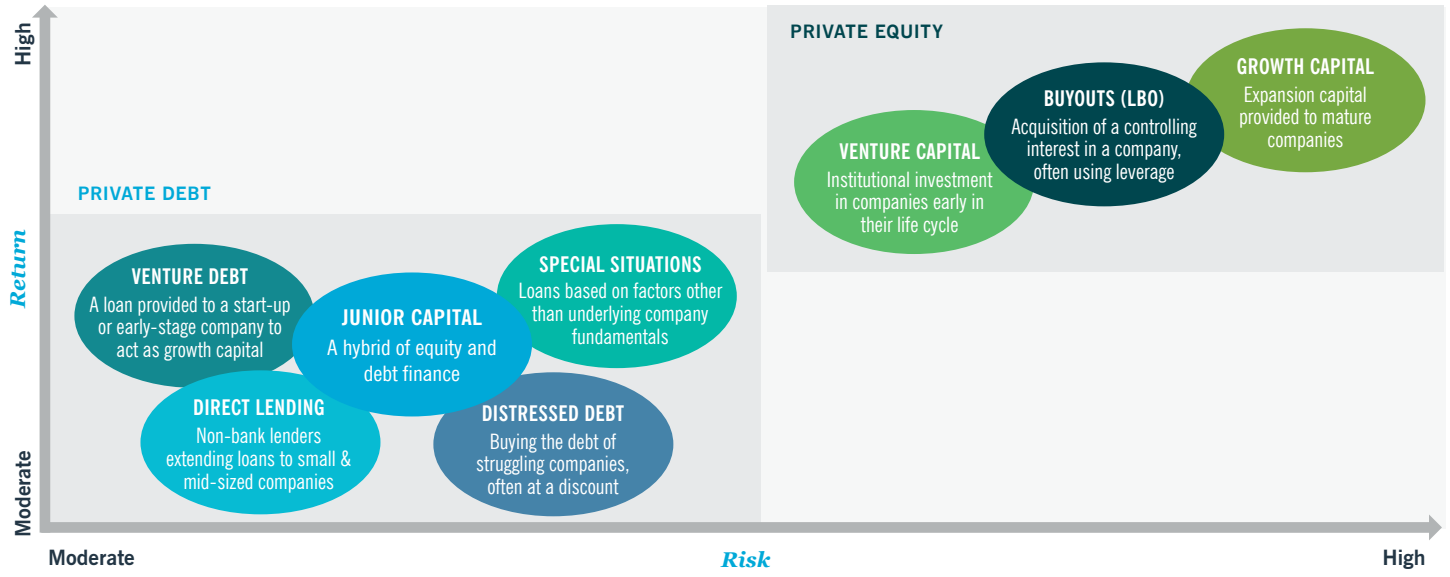
Yield by fixed income sector (%)



Data source: Bloomberg, L.P., Barclays, JPMorgan, Refinitiv LPC, S&P and Giliberto-Levy, 31 Mar 2022. CLOs – equity data as of 31 Dec 2020. Average yield for emerging markets corporates since 31 Dec 2001, preferreds since 31 Mar 2012. **Past performance does not guarantee or predict future results.** The yield quoted is yield-to-worst except for these sectors: senior loans – yield-to-maturity; senior lending – average first lien 3-year term loan yield; CLOs-BB rated – simple average yield; junior capital – issuance weighted average of the 3-year term middle market second lien loan rate and 3-year term mezzanine debt (cash & PIK) rate. **Representative indexes: CLOs – BB rated:** JPMorgan U.S. CLO Index – BB rated; **CLOs – equity:** 31 Dec 2020 Barclays U.S. BSL CLO Equity Distributions (IO) median; **emerging markets corporates:** JPMorgan CEMBI Diversified Index; **emerging markets sovereigns:** JPMorgan EMBI Global Diversified Index; **high yield corporates:** Bloomberg U.S. Corporate High Yield 2% Issuer Capped Index; **investment grade corporates:** Bloomberg U.S. Corporate Investment Grade Index; **junior capital:** Refinitiv LPC; **non-U.S. corporates:** Bloomberg Global Aggregate Ex USD – Corporate Index; **non-U.S. sovereigns:** Bloomberg Global Treasury (Ex US) Index; **preferred securities:** ICE BofA U.S. All Capital Securities Index; **real estate debt:** Giliberto-Levy Commercial Mortgage Performance Index (G-L 1); **senior lending:** Refinitiv LPC; **senior loans:** S&P/LTSA Leveraged Loan Index; **U.S. securitized:** Bloomberg U.S. Aggregate Securitized Index.

Against this backdrop, investors are increasingly investing across the credit spectrum to broaden their search for yield and differentiate their fixed income risk exposures. But the opportunity set is broad and complex, spanning multiple forms of private debt, as well as private equity. Our focus here is private credit, including direct lending and junior capital. Implementation and access present challenges.

Figure 2: Private capital offers diverse risk/return opportunities



Asset category risk and yield parameters are presented for illustration purposes only and do not represent actual or expected outcomes.

PRIVATE CREDIT INVESTORS SHOULD CONSIDER 5 IMPORTANT FACTORS

Private credit markets have traditionally attracted more institutional investors, but access to these markets is growing. We believe individual investors should consider five important factors as they look to efficiently harness the illiquidity premium and diversification benefits of private credit.

1. Selectivity and rigorous underwriting are paramount.

Selective, rigorous underwriting is central to the success of a private credit strategy in any environment. Investors should be particularly mindful of these factors:

Sector exposure. Consider targeting defensive sectors, such as health care, business services, financial services and technology, particularly companies with pricing power that can pass input cost increases onto their customers. Even in defensive sectors, it is critical to assess a company's exposure to rising labor costs and other supply chain disruptions.

Exposure to rising interest rates. The floating-rate nature of senior middle market loans provides a rate and inflation hedge to investors in a rising rate environment. But it also means higher interest expense for borrowers, which can have a negative impact on the credit risk of borrowers with weak balance sheets. Hence, the need for rigorous underwriting is especially important in a volatile and rising rate market driven by inflationary pressures.

COVID-related impacts. Determining a company's ability to meet its post-pandemic debt obligations requires understanding what demand will look like as consumer behavior and regulations continue moving toward normalization.

Covenants. Traditional middle market senior direct lending remains conservatively structured, with lender-friendly covenants and loan-to-value ratios. One highly protective covenant may outweigh the value of multiple, weaker covenants.

2. Private equity sponsorship provides additional protection.

One lesson learned in the last two economic downturns is that lending to private-equity-backed companies can provide an additional level of protection for direct lenders. Private equity sponsors provide additional capital (called an equity infusion) that can help a business survive a downturn and identify potential issues that could threaten a borrower's solvency.

Lending to companies where private equity accounts for at least 50% of the capital structure creates natural alignment between the lenders and sponsors, who are the primary source of long-term capital for the business. By observing how private equity sponsors have responded historically to other portfolio companies that have encountered trouble, a lender can get a sense for how committed the private equity sponsor will be to reinforcing a company during a downturn.

3. Managers have multiple levers to add value.

Private credit provides managers multiple ways to generate alpha for investors beyond simply credit analysis and underwriting skill.

Origination: Access to a steady flow of new deals from high-quality companies generates origination fees for the manager and empowers the manager to maintain selectivity and lender-friendly loan structures. Managers with a proven track record and strong network of relationships with private equity sponsors have a significant advantage.

Active management: Managers typically deploy capital one opportunity at a time, allowing them to be very deliberate and intentional. This highly active, opportunistic approach makes idiosyncratic risk a large driver of the asset class's return.

***Access to private credit markets** is growing.*

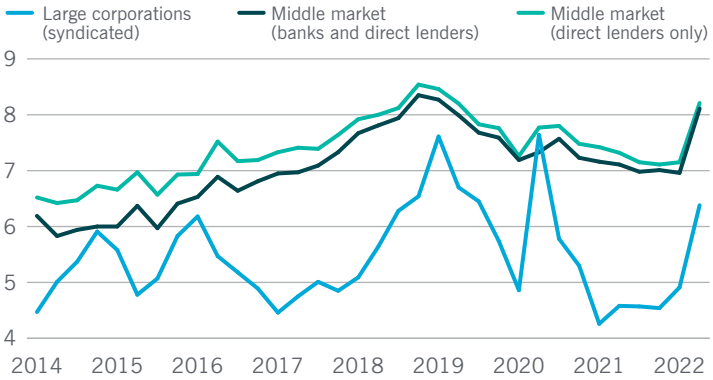
4. Private credit has offered higher yields than public credit.

A primary reason to use private credit is to harness the illiquidity premium. The starting premium that private credit pays over its public liquid-credit counterparts can vary significantly over time, but on average should lead to higher levels of investment income, all else equal.

According to Refinitiv, the yield spread between directly originated, first-lien term loans to middle market companies and syndicated loans to large companies has averaged 1.9% since 2013 and stands at 1.8% as of 30 June. (Figure 3).

Figure 3: The illiquidity premium has averaged 1.9% over time

First-lien term loan yields (quarterly, %)



Data source: Refinitiv LPC, 31 Dec 2013 - 30 Jun 2022. **Past performance does not guarantee or predict future results.**

Extending private capital to borrowers is ***an active management process.***

5. Private equity co-investment and junior capital may help boost yield.

Related assets on the credit spectrum can act as diversifiers and help boost yield within private capital portfolios. Private capital (including private equity and private credit, Figure 2) helps create new exposures within traditional portfolios, while also increasing overall income and return potential.

An equity co-investment is a minority investment in a company made by investors alongside a private equity fund manager or venture capital firm. Co-investing offers investors the opportunity to increase exposure to attractive assets but at lower fees – helping produce higher potential returns.

Junior capital can be an attractive source of incremental yield. It can take on multiple variations, such as subordinated notes (fixed rate) and second lien term loans (floating rate).

PARTNERING WITH THE RIGHT MANAGER IS KEY

Private credit investments can help meet the growing demand for yield, return and diversification. But choosing the right partner is critical, due to the uniqueness of individual deal structures and the wide variety of idiosyncratic factors. Extending private capital to borrowers is an active management process. A manager's underwriting skill, experience and access to deals play a critical role in mitigating risk, especially when markets are under pressure.

Today's economic conditions highlight the need to work with private capital managers who have accounted for the pressures of a rising-rate, inflationary environment in their underwriting processes. The current environment also requires extra diligence in discerning how a company's revenue and profit margin will be affected by a return to more normalized conditions.

For more information, please visit nuveen.com.

Endnotes

This material is not intended to be a recommendation or investment advice, does not constitute a solicitation to buy, sell or hold a security or an investment strategy, and is not provided in a fiduciary capacity. The information provided does not take into account the specific objectives or circumstances of any particular investor, or suggest any specific course of action. Investment decisions should be made based on an investor's objectives and circumstances and in consultation with his or her financial professionals.

The views and opinions expressed are for informational and educational purposes only as of the date of production/writing and may change without notice at any time based on numerous factors, such as market or other conditions, legal and regulatory developments, additional risks and uncertainties and may not come to pass. This material may contain "forward-looking" information that is not purely historical in nature. Such information may include, among other things, projections, forecasts, estimates of market returns, and proposed or expected portfolio composition. Any changes to assumptions that may have been made in preparing this material could have a material impact on the information presented herein by way of example. **Past performance does not predict or guarantee future results.** Investing involves risk; principal loss is possible.

All information has been obtained from sources believed to be reliable, but its accuracy is not guaranteed. There is no representation or warranty as to the current accuracy, reliability or completeness of, nor liability for, decisions based on such information and it should not be relied on as such. For term definitions and index descriptions, please access the glossary on nuveen.com. **Please note, it is not possible to invest directly in an index.**

Important information on risk

Investing involves risk; principal loss is possible. Debt or fixed income securities are subject to market risk, credit risk, interest rate risk, call risk, derivatives risk, dollar roll transaction risk and income risk. As interest rates rise, bond prices fall. Below investment grade or high yield debt securities are subject to liquidity risk and heightened credit risk. Foreign investments involve additional risks, including currency fluctuation, political and economic instability, lack of liquidity and differing legal and accounting standards. Please note investments in private debt, including leveraged loans, middle market loans, and mezzanine debt, are subject to various risk factors, including credit risk, liquidity risk and interest rate risk.

This information represents the opinion of Nuveen, LLC and its investment specialists and is not intended to be a forecast of future events and or guarantee of any future result. Information was obtained from third party sources which we believe to be reliable but are not guaranteed as to their accuracy or completeness. There is no assurance that an investment will provide positive performance over any period of time.

Nuveen, LLC provides investment advisory services through its investment specialists.

This information does not constitute investment research as defined under MiFID.

nuveen
A TIAA Company

GWP-2331138PG-Y0622P 102703