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A TIAA Company

Think private credit | September 2020

Opportunities today in middle market lending

HIGHLIGHTS

- Private credit may help institutional investors address timely challenges, including generating yield and providing low-volatility, low-correlated returns. But making allocation decisions can be challenging.
- We favor allocations to higher-quality U.S. senior and junior level debt, particularly from health care, business-to-business services and software companies.
- Mezzanine debt may offer opportunities for value and high yield premiums at what may be a market bottom, so we suggest reserving resources for these opportunities.
- Private investing offers a number of levers to help create value, but investment scale, experience and access to relationships are essential.

Private credit has historically been an attractive investment. Historically stable performance and broader knowledge of the asset class have driven an increasing amount of capital into the space.[1]

With regulation and consolidation preventing banks from holding leveraged loans, the void has been filled by private credit managers, finance companies and asset management firms. Growing demand from issuers of private credit, and the appetite from investors, has accelerated fundraising by managers. The more experienced successful managers are effectively crowding out smaller firms.

The U.S. private credit space may appear crowded, with heavy competition and high valuations. However, new opportunities over the past 10 years have not nearly totaled exiting bank capacity. And while private credit fundraising has been robust since 2015, four dollars of private equity uninvested capital exist for every one dollar in private credit.[2] Enterprise valuations have increased as a result, providing higher equitization of private equity-backed companies.

The U.S. private credit market is more mature than the European market, ranking as the world's third-largest economy if it were a country.[3] U.S. managers with scaled origination platforms and strong track records seem likely to take advantage of this larger market, allowing them to be highly selective in adding deals to their portfolios.

We see opportunities for private credit investment in today's environment. We consider a number of investment factors as we determine how to incorporate these investments into an existing asset allocation strategy.

Randy Schwimmer
Head of Origination & Capital Markets, Churchill Asset Management

Jason Strife
Head of Junior Capital & Private Equity Solutions, Churchill Asset Management

Nathan Shetty
Head of Multi-Asset Portfolio Management

Solving for challenges facing investors today

In today's environment of low rates and economic malaise, institutional investors are struggling to deliver yield, drive growth and meet liabilities. We believe private credit is an effective alternative source of income, while providing true diversification.

01

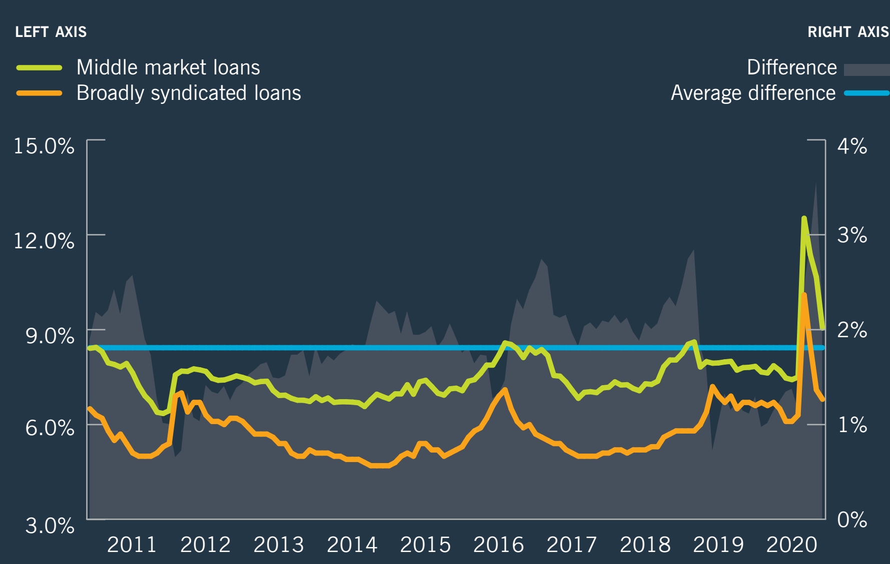
Accessing alternative sources of higher, consistent yield

Middle market loans — with credit risk comparable to broadly syndicated leveraged loans and high yield bonds — have historically boosted portfolio yield, due in part to the illiquidity premium and other factors. The illiquidity premium for middle market loans is currently 2.3%, just over the long-term average of 1.8% (Figure 1).

Amid the current climate of economic uncertainty, middle market loan spreads have widened and leverage multiples have decreased in a more lender-friendly investment landscape. We expect these conditions to persist in the near term, even as deal-making activity recovers from the pandemic-induced slowdown.

FIGURE 1:
The illiquidity premium has averaged 1.8% since the financial crisis

Yield (%)



Data source: LCD/S&P Global, 01 Jun 2010 to 30 Jun 2020. **Past performance is no guarantee of future results.** Representative indexes: broadly syndicated and middle market loans: S&P/LSTA Leveraged Loan Index. Middle market loans are loans to companies with EBITDA of $50 million or less within the S&P/LSTA Leveraged Loan Index. It is not possible to invest in an index.

> We believe the illiquidity premium effectively boosts income/returns in an environment of low rates and tight spreads.

Investing in private credit may be an effective way to achieve diversified growth in today's markets.

02

Finding diversified growth opportunities

In our view, private markets are an attractive way to generate portfolio growth through uniquely structured opportunities. The high levels of customization available and negotiated loan origination inherent in the asset class allow investors to access idiosyncratic risk and alpha generation potential.

Senior and junior credit strategies are a particularly useful way to achieve diversified growth, allowing investors to distinguish credit risk from rate duration risk through floating-rate features (Figure 2). Additionally, these private credit investments' floating rate structures have demonstrated a relatively high short-term correlation to inflation, culminating in hedging properties not typically found in the fixed income asset class.

In low yield environments, with long-term expectations of depressed rates, the fixed-rate element of junior or mezzanine loans can help lock in a portfolio's target yield.

FIGURE 2:
Risk measures vary by asset class

	RISK		
Asset class	**Rate duration**	**Credit spread**	**Liquidity**
Broad bond market	Higher	Lower	Lower
Public high yield corporate	Medium	Higher	Medium
Public loans	Lower	Higher	Medium
Senior private credit	Lower	Higher	Higher
Junior private credit	Lower	Higher	Higher

Data source: Nuveen

Middle market loans have offered stable returns across market cycles, as investors look to counterbalance a broader portfolio.

03

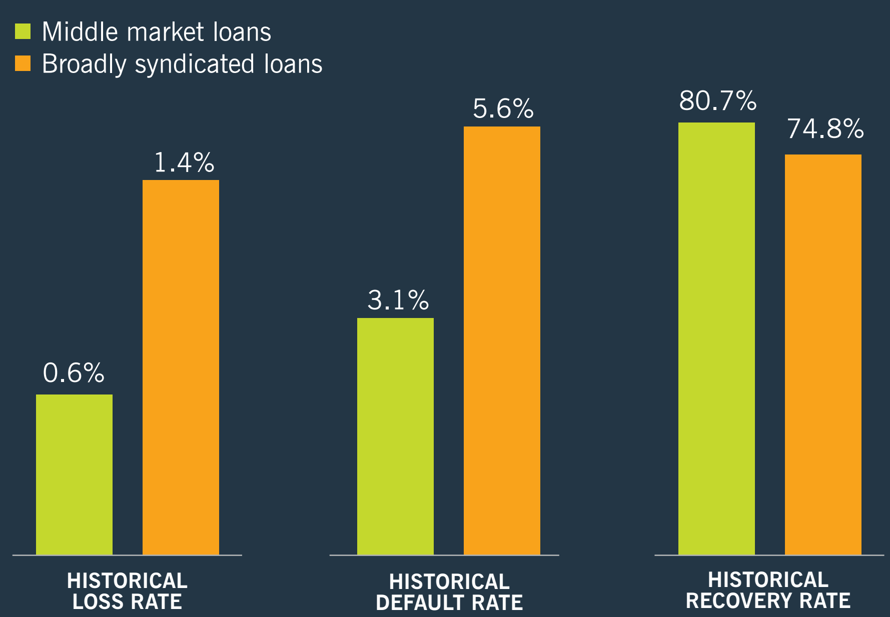
Generating stable returns to meet long-term goals

Middle market loans are typically more conservatively structured with lower leverage multiples, higher interest coverage and tighter covenant packages than broadly syndicated loans.

And, most importantly, private credit assets are illiquid and do not trade. That distinguishes them positively from larger, liquid, public (yet more volatile) assets that are more tightly correlated with market moves. Middle market loan yields have therefore been more stable through multiple business cycles (Figure 3).

FIGURE 3:
Middle market loans are typically more conservatively structured

Performance, 1995 – 2020



Data source: S&P LCD, S&P Credit Pro, 01 Jan 1995 to 30 Jun 2020. **Past performance is no guarantee of future results. Representative indexes: broadly syndicated and middle market loans:** S&P/LSTA Leveraged Loan Index; Middle market loans are loans to companies with EBITDA of $50 million or less within the S&P/LSTA Leveraged Loan Index. It is not possible to invest in an index.

Allocating to private credit

Private credit can play an essential role in managing different risk appetites and achieving distinct objectives. The key for investors is to understand the drivers of risk and return relative to other portfolio exposures.

We believe investing in private credit represents a flight to quality.

Changes to asset allocation can be asymmetric

It is easier to reallocate money from public investments or use unallocated capital than to switch out of illiquid private credit. Once capital is committed to private credit, it usually cannot be divested, so allocations to this asset class should be long term. Private assets are poor candidates for short-term tactical allocations.

When we work with investors to consider specific allocations to private credit, we scrutinize whether the compensation is adequate for the lack of liquidity by considering such factors as:

- What is the investment time horizon?
- Can other sources of income meet immediate needs?
- What are the levels and variability of other income stream sources?

Considerations in today's environment

These considerations hold true across all market environments. But today, with high volatility expected to continue for some time, minimizing downside risk is particularly important.

Instead of a flight from risk, we believe investing in private credit represents a path to quality. Having a priority security interest in the assets and cash flows of the borrower and being senior in the capital structure is precisely the comfort investors should be seeking in uncertain times.

Years of data show middle market loans have lower defaults, lower losses and higher recoveries than their broadly syndicated counterparts. That's because the holders of those loans are buy-and-hold lenders whose interests are aligned with the private equity owners to maximize enterprise value.

As with generating alpha, maximizing recoveries depends on experienced managers navigating credit risk appropriately. In a downturn, top lenders realize that avoiding cyclical borrowers and selecting defensive sectors greatly improves the chances of better recoveries and lower losses.

Attractive opportunities in private credit today

We are focused on investing in directly originated, senior secured loans to private equity-backed, traditional U.S. middle market companies ($10 million to $50 million of EBITDA), which we believe provide an attractive risk/return opportunity for investors.

In our view, it is essential to remain highly selective and focused on building diversified portfolios of loans with 1% to 2% position sizes, conservative leverage multiples, significant sponsor equity contributions and at least one financial covenant per transaction.

Mainly, we look for high quality earnings. In the late stage of the cycle, the owners of these businesses get increasingly aggressive in their financials. We want to ensure we are lending off of actual cash flow and feel confident the business can thrive in a downturn.

Given slowing growth overall, we also look for service-oriented portfolios and business models that are service-centric versus product-centric.

Specialty finance areas — such as equipment or aircraft leasing and music royalties — offer less exposure to broad-based economic trends, providing greater opportunity for idiosyncratic returns and true diversification. However, it is critical to work with the right manager to select the right opportunity due to potentially high dispersion. The tolerance for portfolio illiquidity should be carefully considered.

Where are we finding value today?

We like:

- High free cash flow, recurring revenue, high customer retention models, such as business services, software, select health care and distributors

We avoid:

- Auto, retail, energy, specialty lending (gaming and aerospace), companies pegged to high-end consumers

Rationale:

- Strong EBITDA margins
- Contractual revenue streams
- Better performance during the financial crisis
- Leverageable cash flows and ability for a borrower to deleverage through cash flow

Balancing senior loans with junior debt

Exposure to junior capital is an integral part of an overall private credit portfolio. Junior capital is typically structured as floating rate second lien term debt, fixed-rate subordinated debt, or non-cash-paying but contractually yielding structured notes.

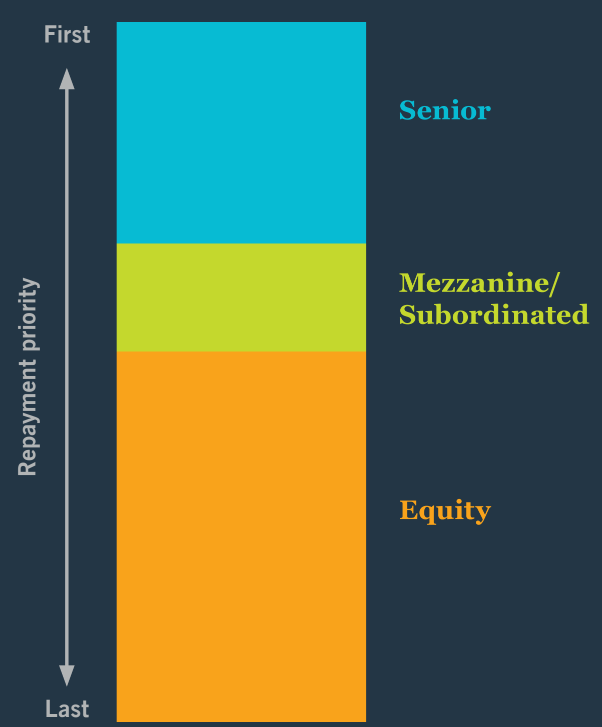
Junior capital offers many of the same attributes as middle market-focused first lien private debt, but with significantly higher contractual returns.

Private equity firms value junior capital as patient, flexible capital to optimize their cost of capital objectives, particularly in high enterprise valuation business models or when tuck-in, buy-and-build strategies are paramount to building enterprise value.

As enterprise valuations continue to expand in the middle market private equity space, junior capital solutions have become an increasingly critical tool to appropriately size equity accounts and add sufficient capacity to support growth.

By targeting businesses with high cash flow margins, durable revenue streams and mission-critical value propositions, the relative value proposition of junior capital can be quite compelling.

FIGURE 4:
Mezzanine debt typically falls second in the capital structure



Partnering with the right manager is critical

Structuring a private credit deal requires more than just private equity. Originating the loans is a key part of the investment process, and most managers have an origination function that entails an active strategy unto itself.

We have developed a strong position in the middle market as a trusted partner to lead traditional senior and unitranche credit facilities, which gives us an important seat at the table in the event of a credit issue. And, ultimately, it is essential to align ourselves with top-tier private equity sponsors with decades of investing success.

We look closely at private equity sponsorship dynamics to determine if the value-creation strategy is sound, as well as evaluating the private equity owner's experience in the sector and in operating a portfolio through an economic downturn. We also consider whether the borrower's capitalization strategy is commensurate with our risk profile and how well the sponsor aligns with portfolio dynamics.

We align ourselves with top-tier private equity sponsors with decades of investing success.

Overall, manager skill involves several key factors:

- Leveraging relationships in the loan origination process
- Investing through a full market cycle
- Knowing how sectors have performed in different environments and how to respond
- Recognizing leverage points in the capital structure in terms of covenants
- Understanding how businesses grow on the upside, while defending on the downside
- Employing a disciplined underwriting process that allows for timely, dependable financing decisions

Financial covenants provide guardrails

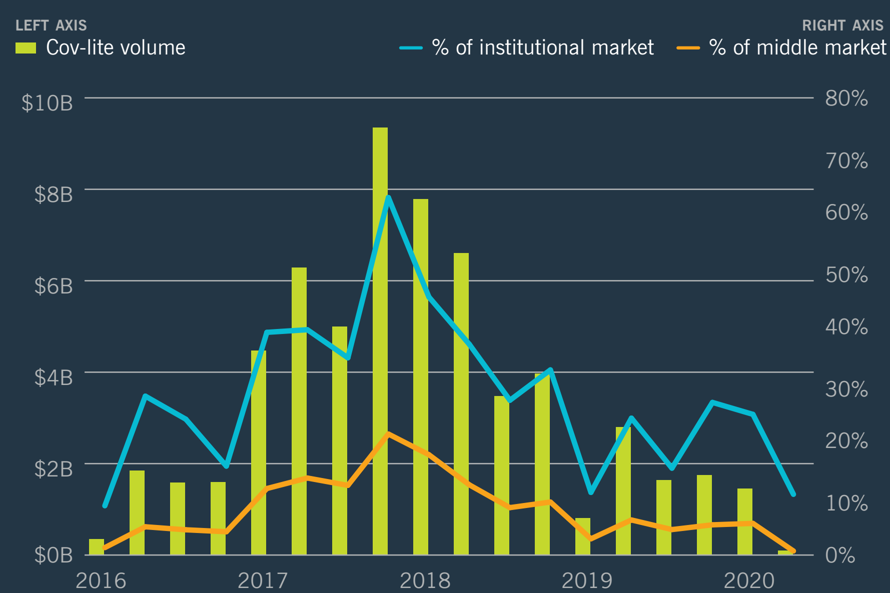
Financial covenants are critical structural elements of credit documentation in the middle market. These guardrails provide an impetus for all parties to review financial performance, allowing for thoughtful, constructive solutions early on.

It's not the quantity of covenants, but the quality. Of greater concern are the building blocks of those covenants; specifically, EBITDA add-backs and adjustments, as well as debt incurrence tests. Experienced lenders with a track record of reviewing thousands of transactions across multiple cycles understand how to analyze these terms and avoid conditions that will erode recoveries and hurt returns.

While deal making activity declined in 2020, we believe leverage levels will likely decline and lenders will be able to obtain more lender-friendly terms as the environment becomes tighter.

FIGURE 5:
Cov-lite market share collapsed in second quarter 2020

Middle market covenant-lite volume



Data source: Refinitiv LPC, 01 Jan 2016 to 30 Jun 2020. Data represents loans of up to $350 million.

An attractive asset class partnering with the right active manager

We think private credit is an extremely resilient asset class and could be a permanent part of any institutional investor's portfolio.

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

- Middle market loans can boost portfolio yield, due in part to the illiquidity premium.
- High levels of customization allow investors to access idiosyncratic risk and alpha generation potential.
- Middle market loan yields have been more stable through multiple business cycles.

But due to the complexity of deal structure and the wide variety of idiosyncratic factors inherent in different deals, choosing the right partner is critical.

Middle market private lending is by definition an active management process. When there is pressure on markets, active management is required to mitigate those risks with underwriting standards.

But not all active managers are the same. Recent upheaval in the private capital markets due to the coronavirus pandemic suggest that private equity firms should be gravitating to scaled, unlevered capital providers who can provide greater certainty for execution. Private capital platforms like Churchill that partner with large asset management firms are well-positioned continue growing market share given their superior value proposition.

Drawing on the resources of a globally known asset manager, Churchill is a reliable and consistent partner with a track record spanning economic cycles. It has the capability to invest at various levels of the capital structure, and its unique origination model provides proprietary investment opportunities from established relationships in the private equity community.

Middle market private lending is by definition an active management process.

Investing with Nuveen

Nuveen offers solutions for a range of institutional investors. We provide investors access to liquid and illiquid alternative strategies, such as real estate, real assets (farmland, timber, infrastructure), private equity and debt, in addition to both traditional and fixed income assets.

Access to these strategies includes pooled funds, separate accounts and co-investment opportunities.

Our heritage as a pension fund means we understand the challenges other like-minded investors face. We have successfully been investing through market cycles for more than 100 years, for both ourselves and our investment partners.

We work closely with our clients to understand their requirements and develop forward-thinking investment opportunities.

Short-lived market cycles, evolving investor needs and sustainability pressures bring significant opportunities and challenges. We focus on three investor objectives across all of our client solutions:

- Generating income and capital growth
- Managing risk in a world of ongoing uncertainty
- Managing assets cost-effectively via optimal scale and access

For more information, please visit nuveen.com.

Endnotes

1 Data source: Cliffwater Direct Lending Index (CDLI), 01 Jan 2005 to 31 Dec 2019.

2 Data source: Prequin, 31 Aug 2019.

3 Data source: The National Center for the Middle Market.

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Glossary

Correlation is a statistical measure of how two securities move in relation to each other. Perfect positive correlation (a correlation co-efficient of +1) implies that as one security moves the other security will move in lockstep, in the same direction. Alternatively, perfect negative correlation (a correlation co-efficient of -1) means that securities will move by an equal amount in the opposite direction. If the correlation is 0, the movements of the securities are said to have no correlation; their movements in relation to one another are completely random. **Covenant** is a promise in an indenture, or any other formal debt agreement, that certain activities will or will not be carried out. Covenants in finance most often relate to terms in a financial contract, such as a loan document or bond issue stating the limits at which the borrower can further lend. **Earnings before interest, taxes, and amortization (EBITA)** refers to a company's earnings before the deduction of interest, taxes, and amortization expenses. It is a financial indicator used widely as a measure of efficiency and profitability. **S&P/LSTA Leveraged Loan Index** is designed to reflect the performance of the largest facilities in the leveraged loan market. S&P Middle Market Index provides investors with a benchmark for mid-sized companies, reflecting the distinctive risk and return characteristics of this market segment.

A word 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.

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