



# PRIVATE DEBT OUTLOOK & REVIEW

SAN BERNARDINO COUNTY  
EMPLOYEES' RETIREMENT  
ASSOCIATION

MARCH 13, 2025

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# TOPICS

- Private Debt Outlook
- Year-in-Review & Outlook
- Key Themes

# 2025 NEPC PRIVATE DEBT OUTLOOK

As we head into 2025, investors should be cognizant of the various ways the private debt markets have expanded and evolved over the past year. Deal activity is expected to increase, which would bode well for new deployment as well as refinancings and realizations in existing portfolios. However, the third year of elevated rates, increased competition, industry consolidation and growth of different types of implementation vehicles are reasons for heightened emphasis of manager selection.

**Transitional Capital:** As elevated rates continue, there is now a split between “**Have vs. Have Nots**”. While higher quality companies should be able to find cheaper capital, those that have not grown into their capital structures or face liquidity challenges may have difficulty accessing traditional financing. The deals are a more customized form of financing, allowing managers to create highly structured deals with built-in **optionality** that offers GPs: 1) higher overall return premiums through complexity and/or upside participation and 2) better protections with more control especially around exits.

**Bank Displacement Continues:** Due to regulatory pressure, banks continue to pull back from several markets. The **financing gaps being left behind provide opportunities** for private debt managers to step in and offer alternative solutions for borrowers.

**Portfolio Finance:** There has been an increase in strategies designed to address the lack of realizations across private markets. LPs and GPs alike are increasingly seeking bespoke solutions to help them achieve asset-level, portfolio-level and/or other strategic goals. While deal flow has been muted in the past, this opportunity has **started to materialize**.



# 2025 PRIVATE DEBT THEMES

**Year 3 of higher rates as well as continued regulatory developments will provide interesting new opportunities but also challenge existing portfolios in 2025...**

**...These factors continue to put stress on existing capital structures, accelerated bank retrenchment and create portfolio concerns...**

## Transitional Capital

- Credit Opportunities, Stressed, Distressed
- Opportunistic Direct Lending

## Bank Displacement Continues...

- Asset-Based Lending
- Europe

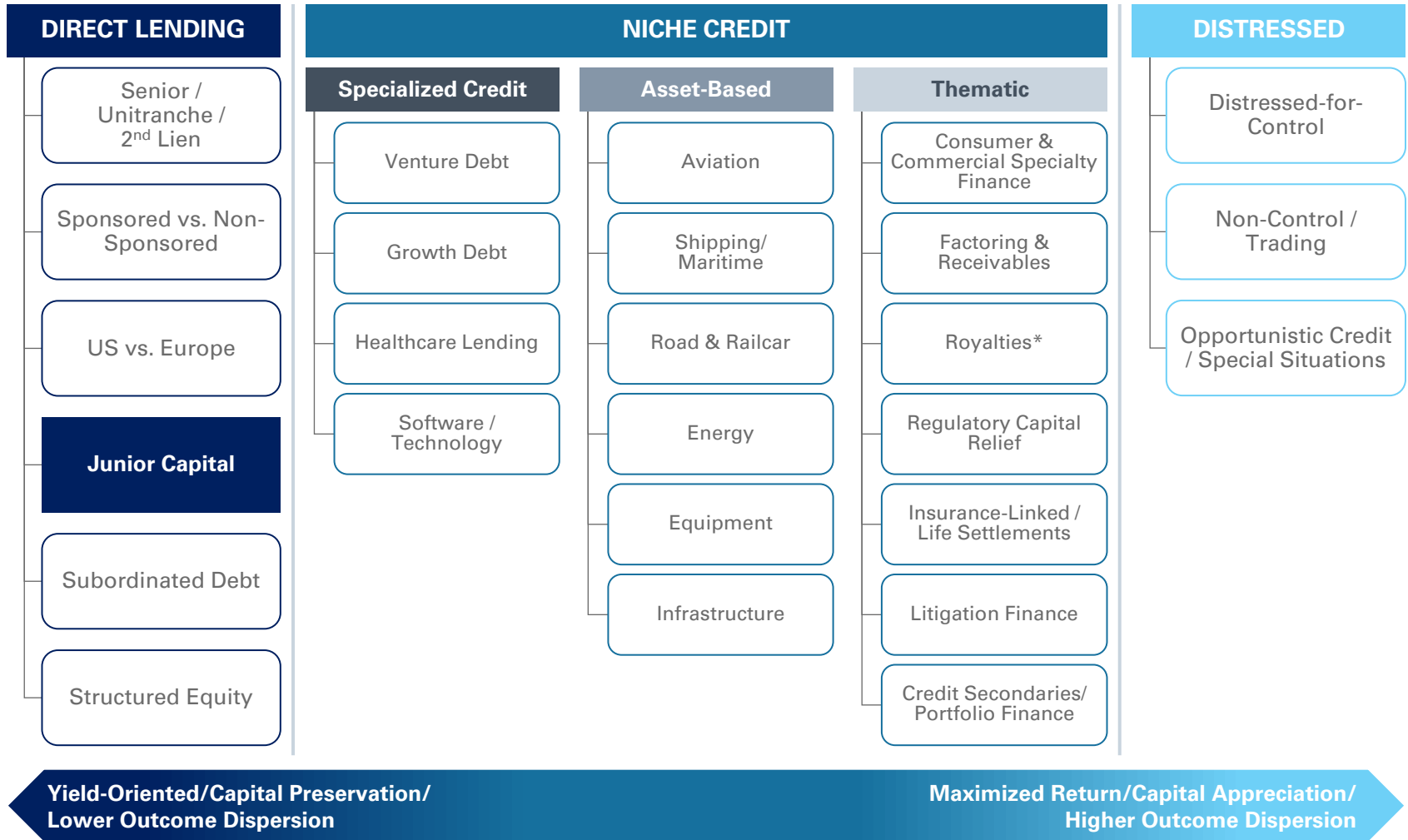
## Private Markets Liquidity: Portfolio Finance

- Credit Secondaries
- GP/LP Structured Solutions

# 2025 PRIVATE DEBT THEMES

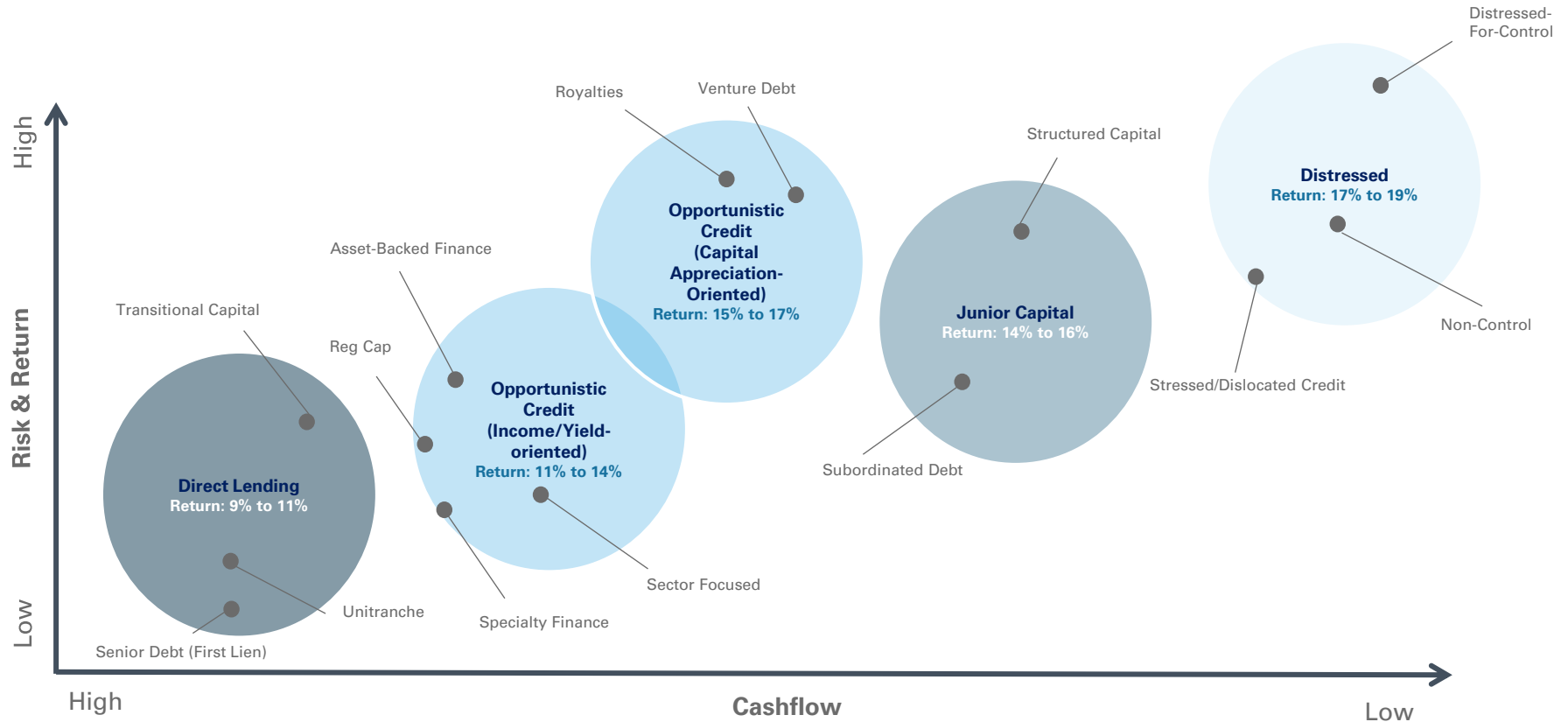
Theme	Overview	Merits	Risks	Implementation
<b>Transitional Capital</b>	<p>Companies have not been able to re-invest or grow; double digit interest expense has consumed a significant amount of liquidity in 2024</p> <p>Borrowers are in need of creative/bespoke financing solutions</p>	<p>Optionality: Lenders have negotiating power to drive more favorable terms including better protections and, in some cases, equity upside</p>	<p>Subordination/priming</p> <p>Lack of equity support</p> <p>Poor deal structuring</p> <p>Lender-on-lender violence</p> <p>Sponsor-on-lender violence</p>	<p><b>Benefit to Client Portfolios</b> Return enhancement</p> <p><b>Strategy Options</b> Opportunistic Direct Lending Opportunistic credit Distressed/stressed</p>
<b>Bank Displacement Continues...</b>	<p>Due to regulatory pressure, banks continue to pull back from several markets</p> <p>Investment types include single asset loan originations, whole loan portfolios, securitizations, non-performing loans, specialty finance, non-bank originators, etc.</p>	<p>Private debt managers can partner with banks to create mutually beneficial solutions</p> <p>Lenders can gain access to potentially high-quality borrowers/assets that otherwise would not typically be available</p>	<p>Poor credit selection</p> <p>Selectivity/adverse selection</p> <p>Incorrectly valuing or understanding collateral</p> <p>Potential for limited control of a workout/restructuring</p>	<p><b>Benefit to Client Portfolios</b> Diversification Return enhancement</p> <p><b>Strategy Options</b> Asset-based lending European private debt</p>
<b>Private Markets Liquidity: Portfolio Finance</b>	<p>LPs are in search of capital solutions for portfolio management reasons (ex. liquidity needs, rebalancing, etc.) and strategic goals (ex. change in mandate, relieve administrative burden, etc.)</p> <p>GPs are seeking financing for fund &amp; asset-level purposes (ex. extend duration to maximize value, crystalize performance, etc.) and strategic goals (ex. balance sheet capital, develop new product offerings, etc.)</p>	<p>A significant increase in total deal flow, coupled with a broader opportunity set in terms of new forms of deal structures, enables managers to be more selective with investments and hopefully achieve better risk adjusted returns</p>	<p>Counterparty risk</p> <p>Inadequate price discount</p> <p>Misalignment/poor deal structuring</p> <p>Underperformance of underlying portfolio companies</p>	<p><b>Benefit to Client Portfolios</b> Diversification Shorter duration</p> <p><b>Strategy Options</b> Credit secondaries Structured solutions</p>

# NEPC PRIVATE DEBT TAXONOMY



# STRATEGY SELECTION

## CASHFLOW & RETURN PROFILE

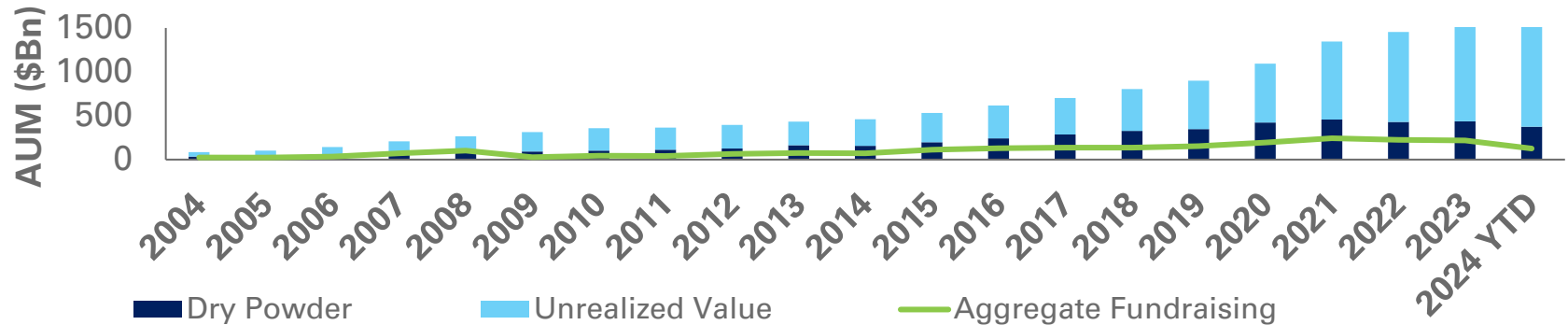




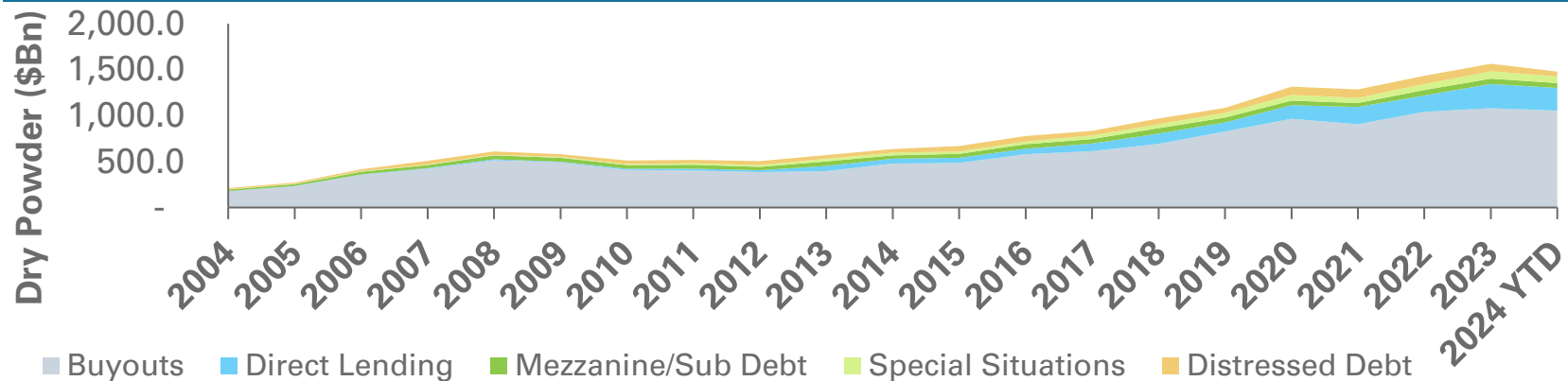
# PRIVATE DEBT ASSETS UNDER MANAGEMENT

CONTINUED GROWTH BUT STILL MEANINGFULLY TRAILS PE

Private Debt Assets Under Management

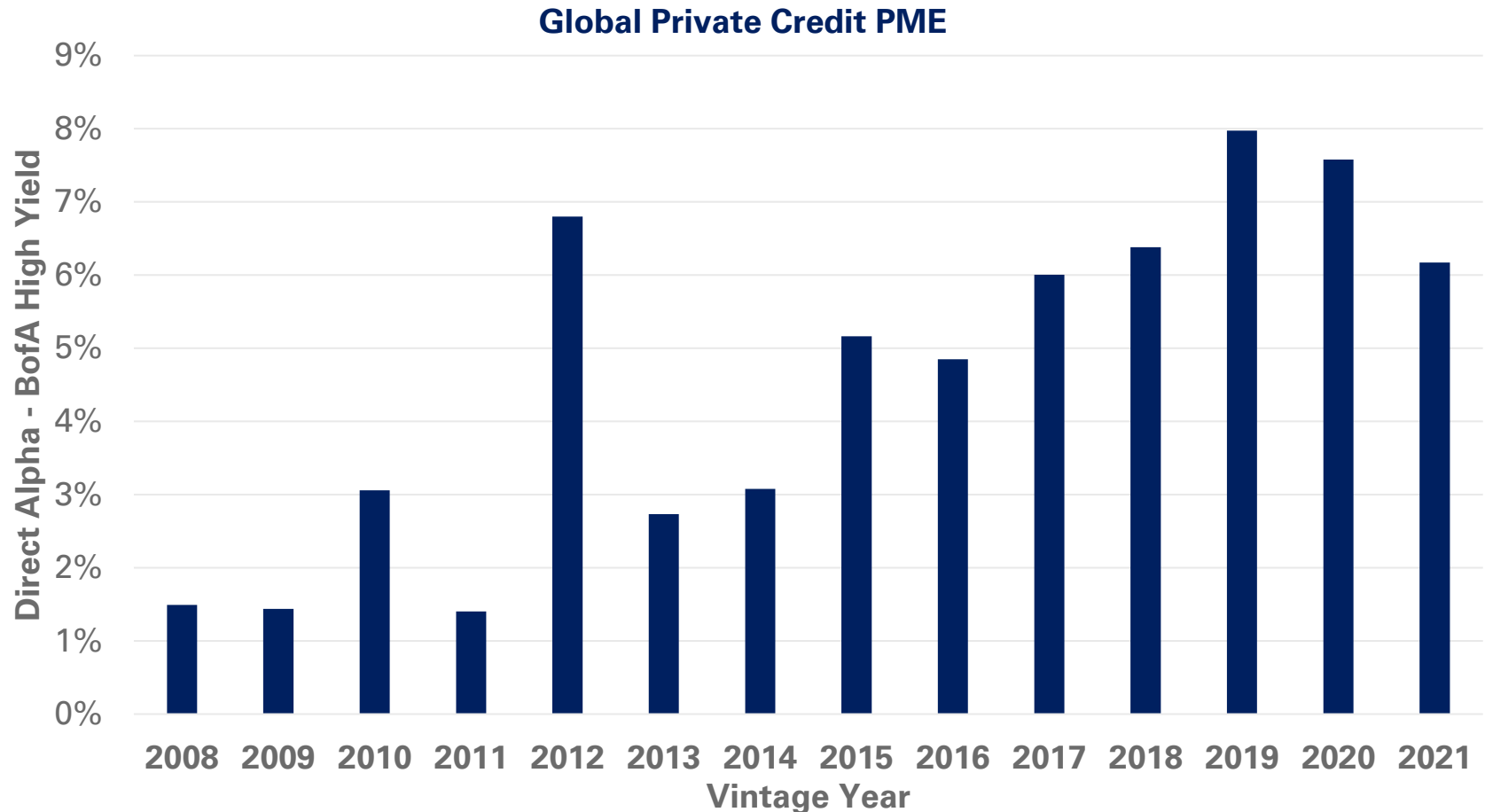


PD vs. PE Dry Powder



# PUBLIC MARKET EQUIVALENT (“PME”)

CONSISTENT OUTPERFORMANCE BUT NOT ENTIRELY CYCLE TESTED



Source: Thomson One/C|A and BofA Merrill Lynch as of 06/30/2024

PD Out/Under-performance is shown based on a PME using the pooled cash flows of all funds across Private Credit

PME method is Direct Alpha and benchmark is BofA HY Index as of 06/30/2024

No NEPC clients are in vested in these exact strategies and have not achieved these returns – for illustrative purposes only.



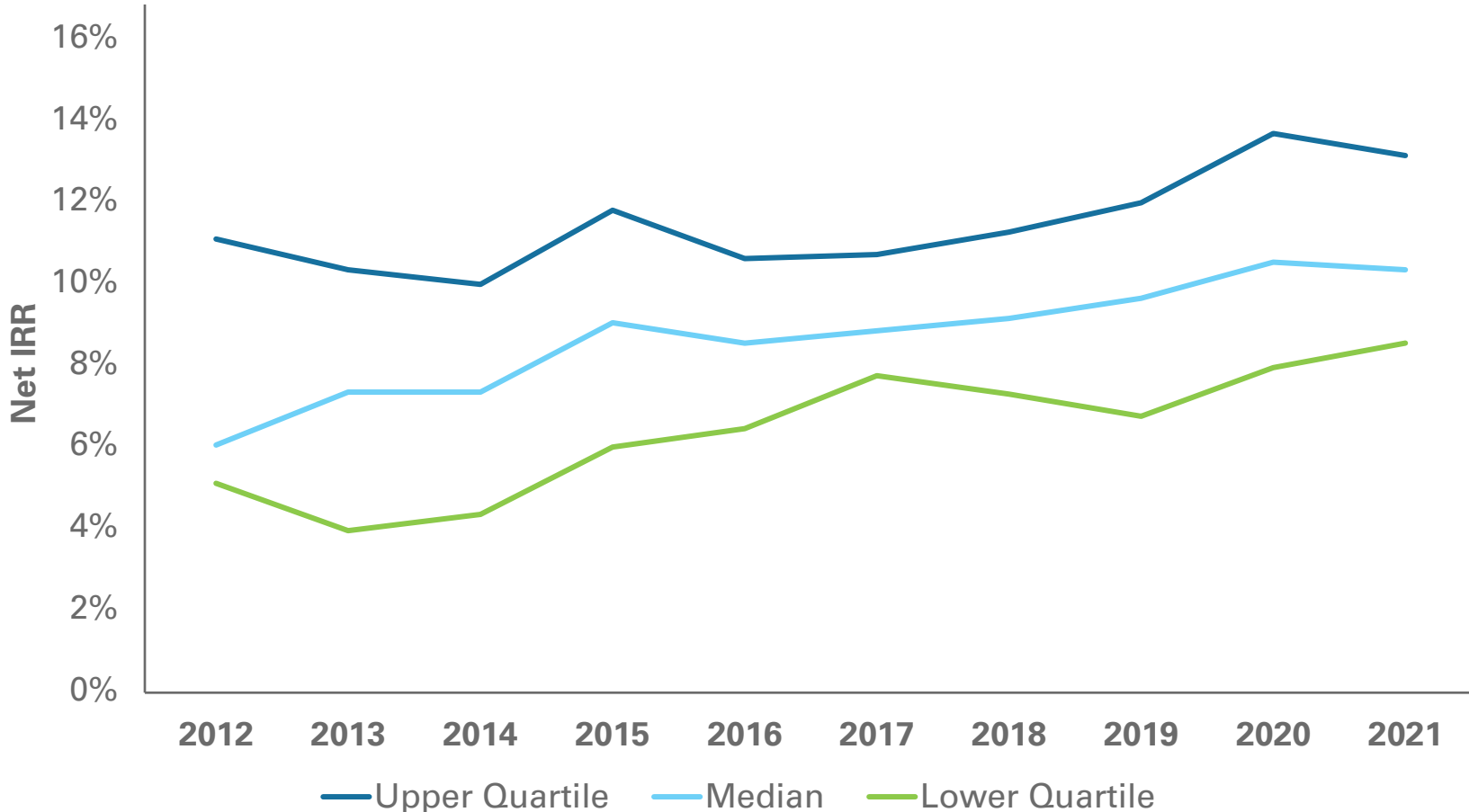
# YEAR-IN REVIEW

## DIRECT LENDING



# DIRECT LENDING PERFORMANCE

RELATIVELY STABLE OVER TIME



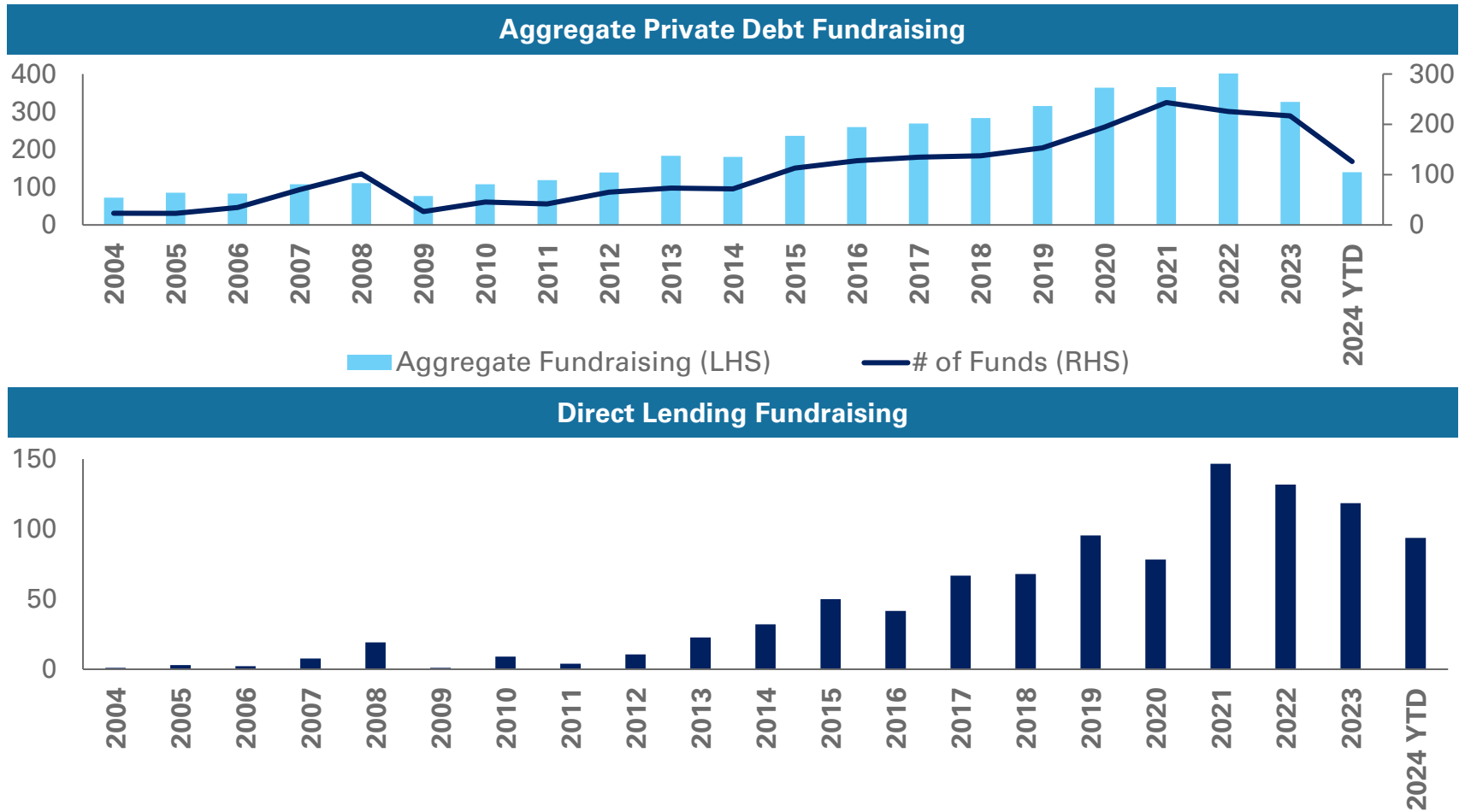
Source: Preqin as of 09/30/2024

No NEPC clients are invested in these exact strategies and have not achieved these returns – for illustrative purposes only.



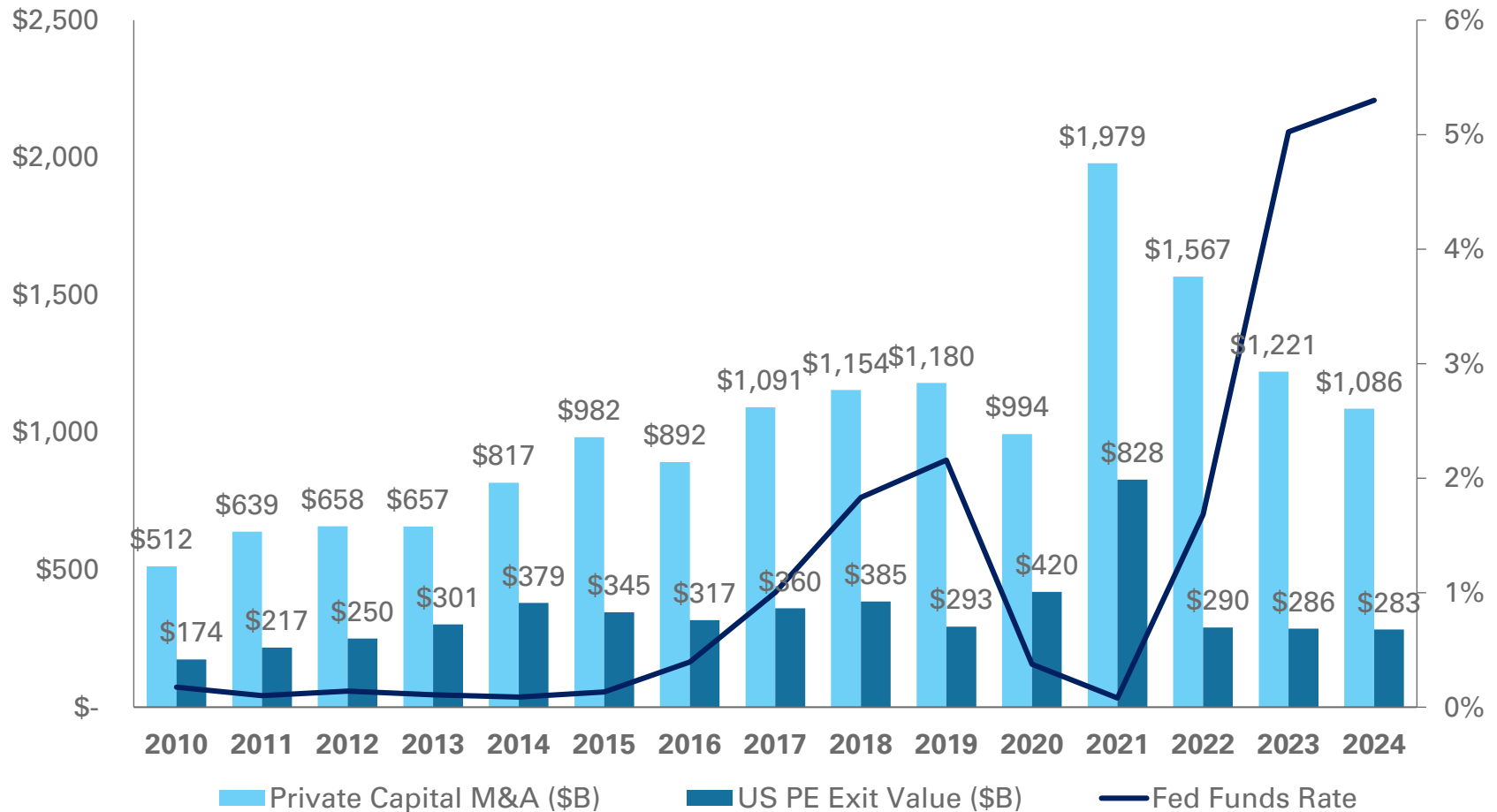
# FUNDRAISING

DIRECT LENDING IN-LINE YOY WHILE OTHER STRATEGIES LAG



# M&A ACTIVITY

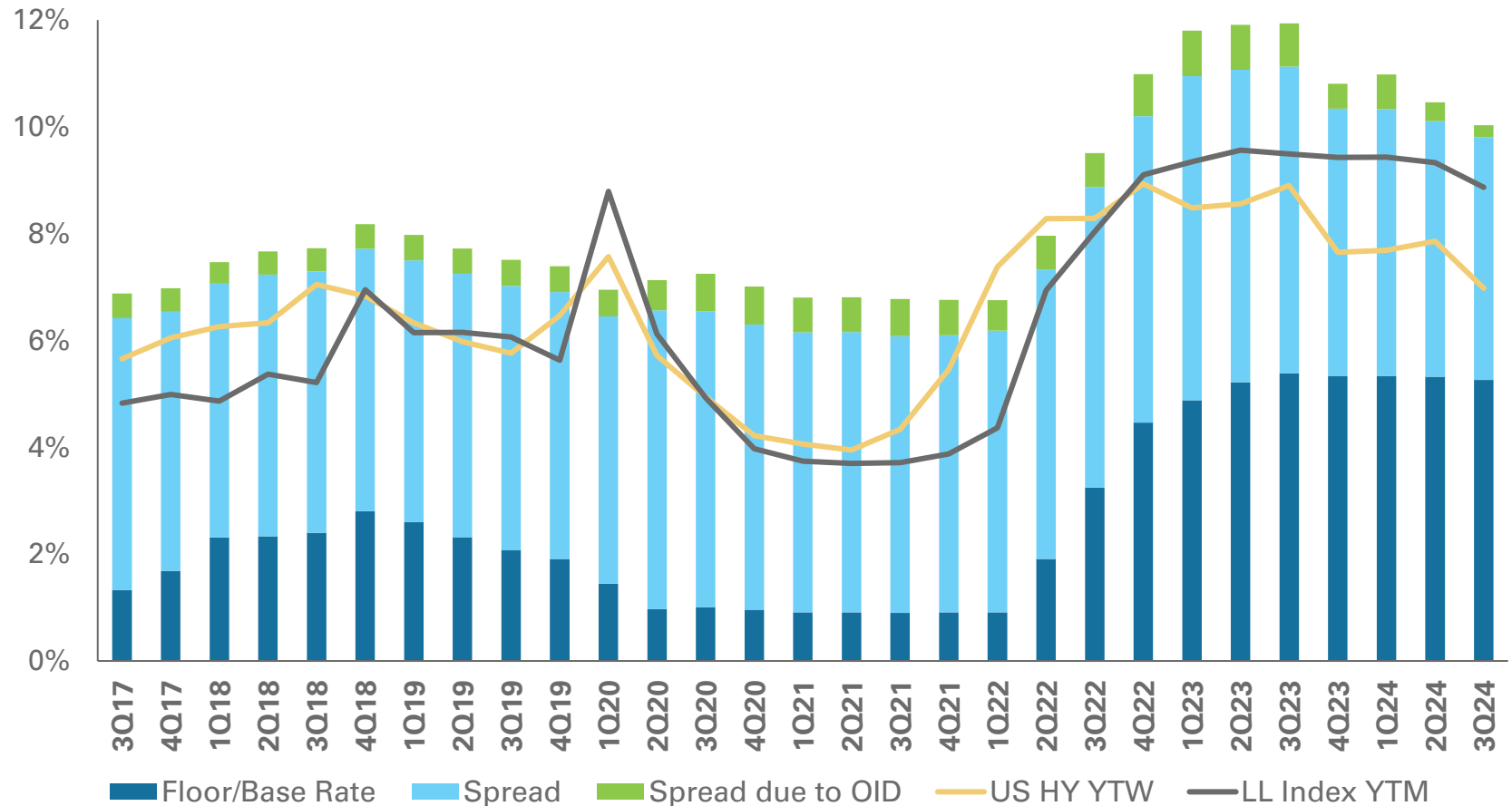
## PRIVATE CAPITAL M&A DECLINING SINCE RATE HIKES BEGAN





# PUBLIC VS. PRIVATE YIELD COMPARISON

## MIDDLE MARKET YIELDS STILL GENERATING PREMIUM

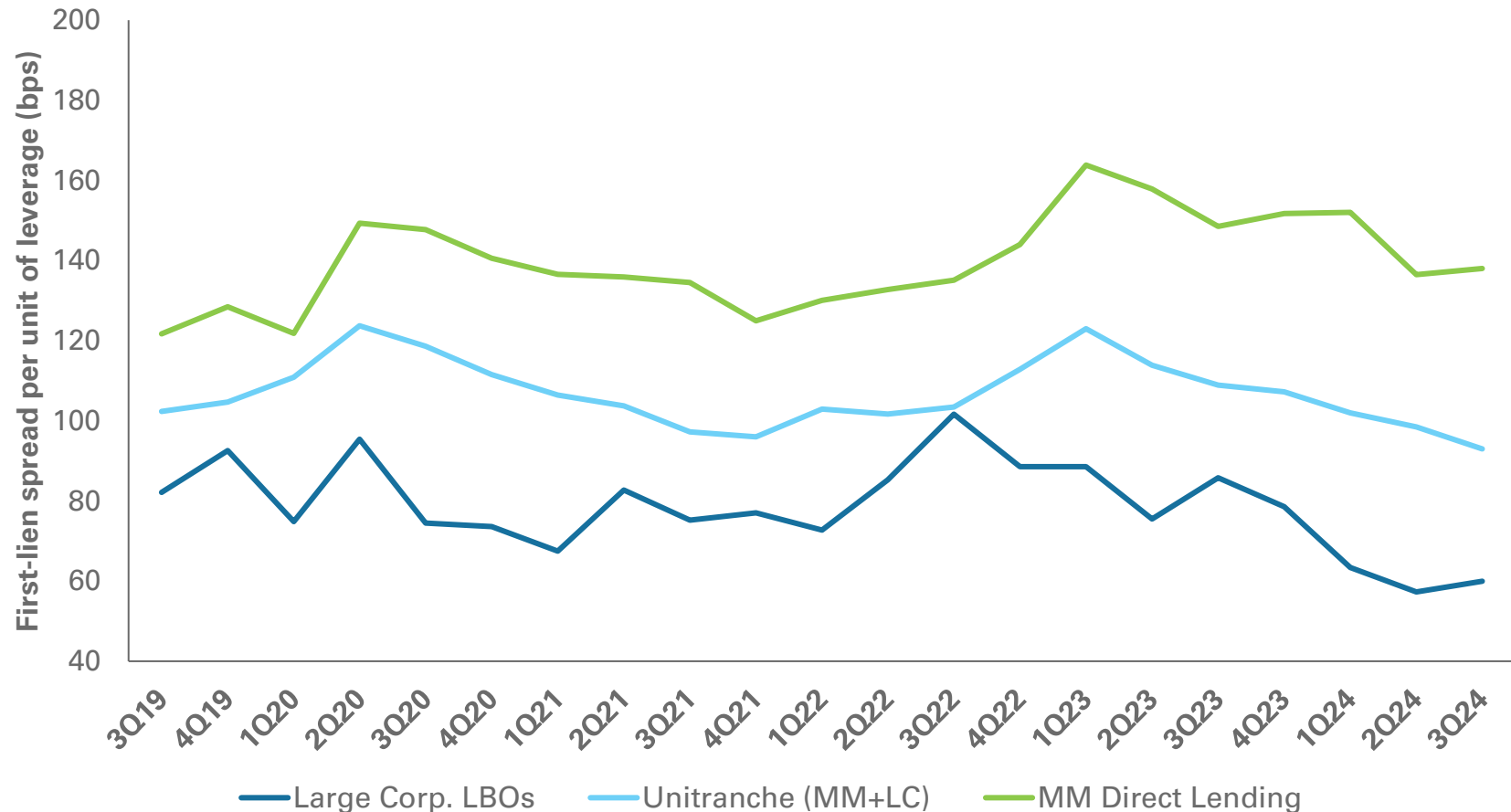


Source: LSEG LPC, FactSet, Bloomberg



# SPREAD PER UNIT OF LEVERAGE

MIDDLE MARKET COMPANIES STILL BETTER PROTECTED IN HIGHER RATE ENVIRONMENT

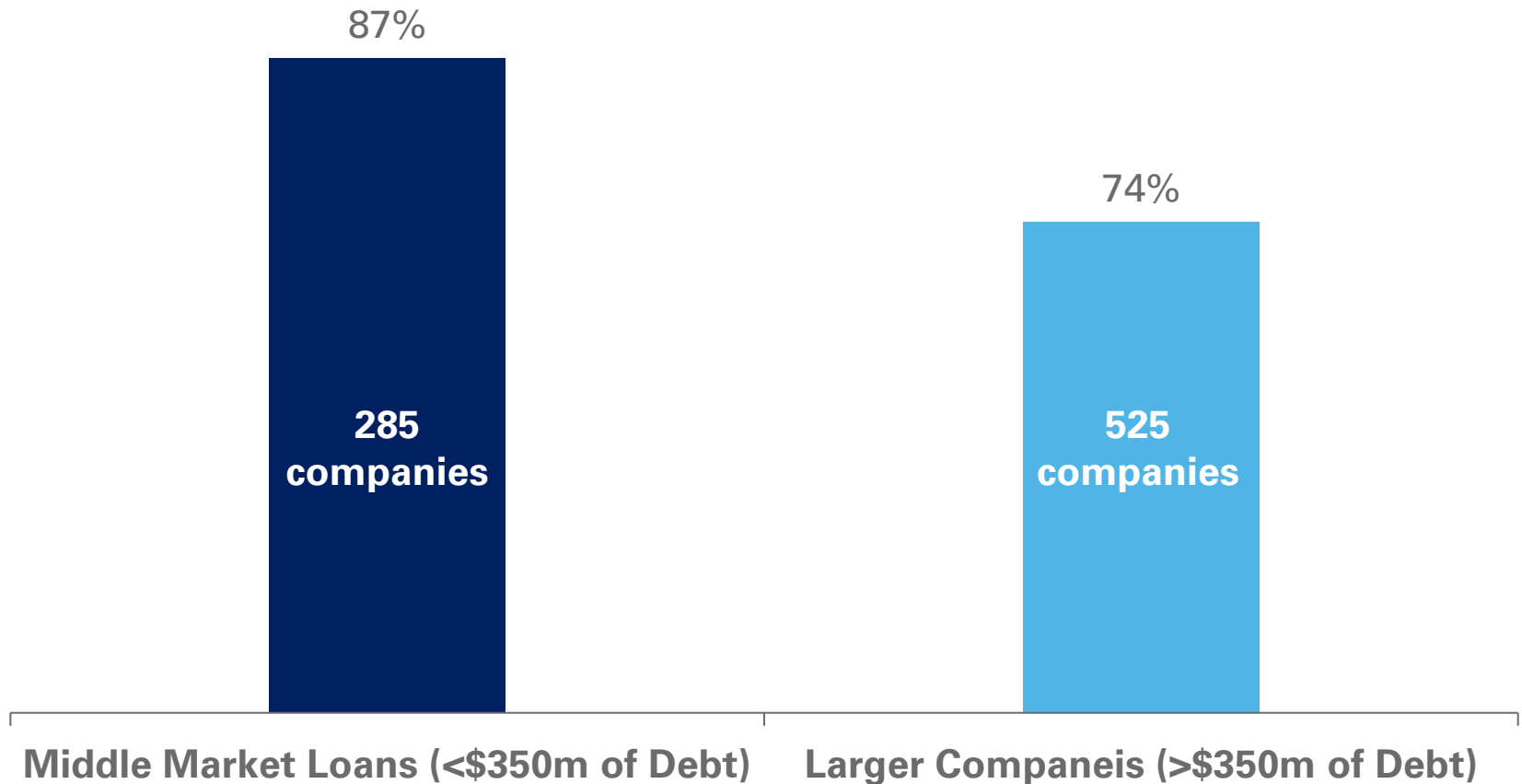


Source: LSEG LPC

# RECOVERY RATES

## MIDDLE MARKET DIRECT LENDING DEMONSTRATES RESILIENCE

### Average Nominal Recovery Rates – First Lien Term Loans



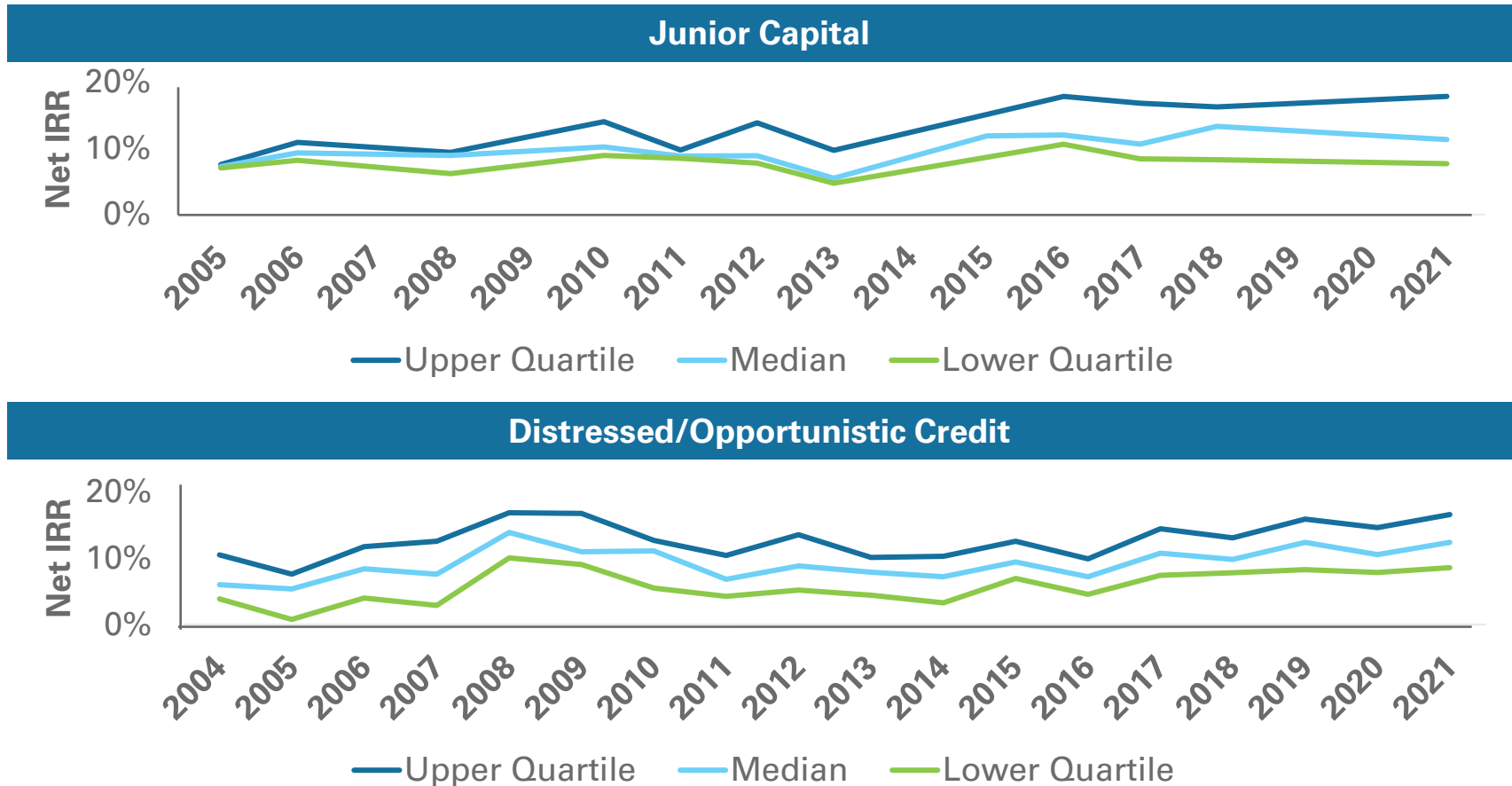
# YEAR-IN REVIEW

DISTRESSED/  
CREDIT OPPS/  
JUNIOR CAPITAL



# PERFORMANCE

## HEIGHTENED IMPORTANCE ON MANAGER SELECTION



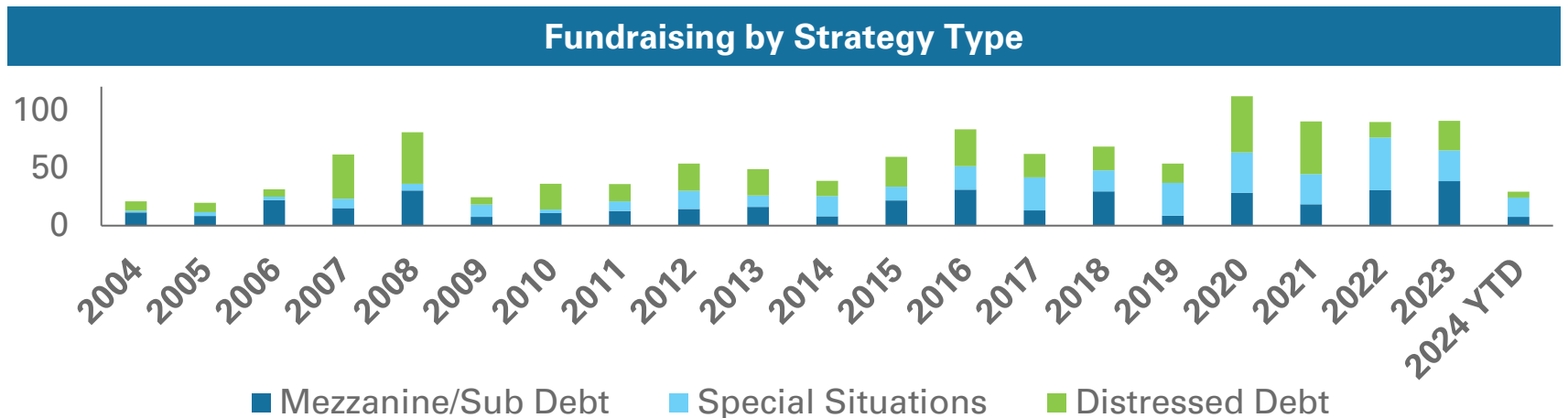
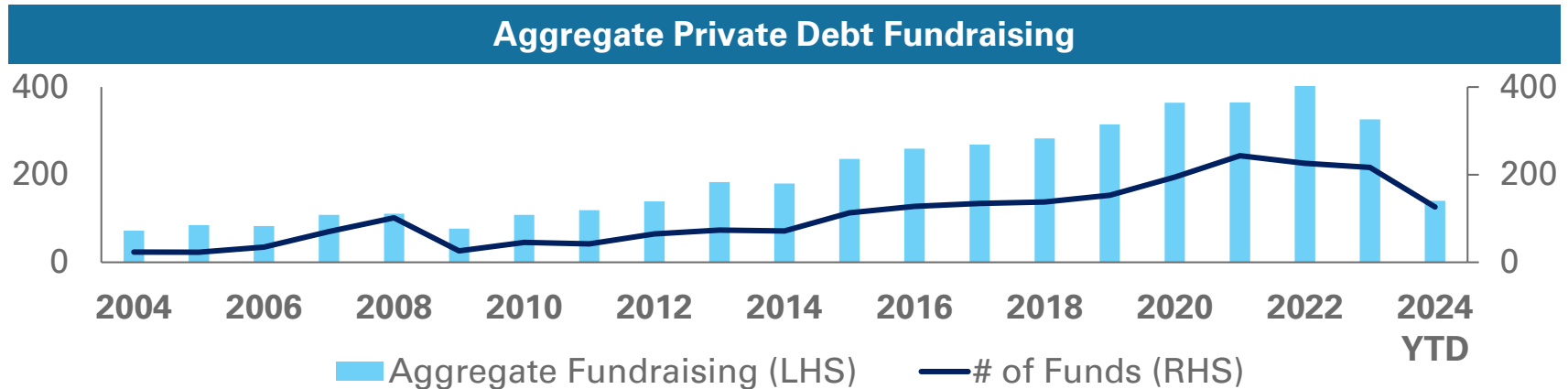
Source: Thomson One/CJA as of 06/30/2024

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# FUNDRAISING

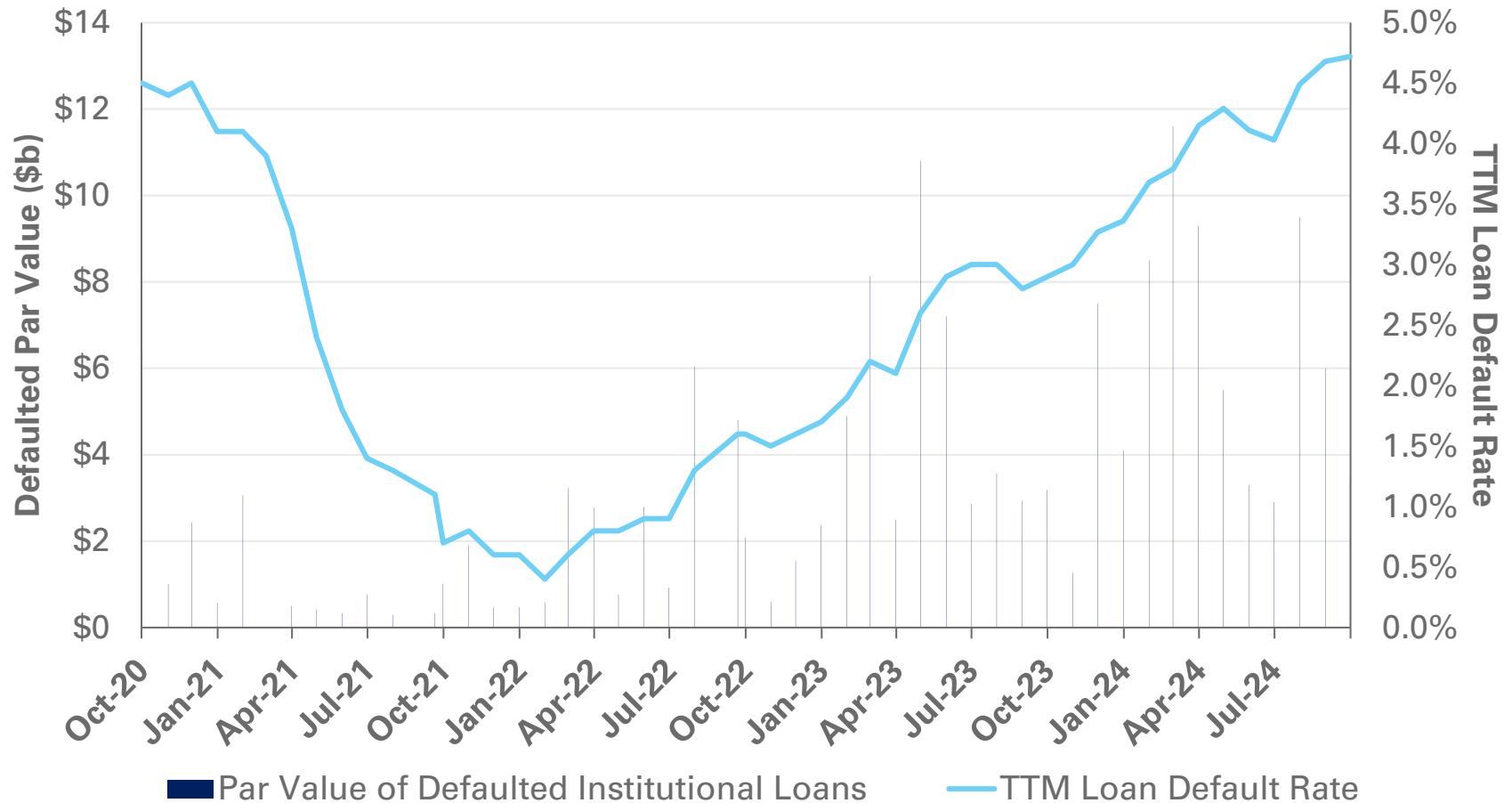
## 2024 DECLINE FOR NON-DIRECT LENDING STRATEGIES





# INSTITUTIONAL LOAN MARKET

## DEFAULT RATE IS RISING



# YEAR-IN REVIEW

## INDUSTRY DEVELOPMENTS



# INDUSTRY CONSOLIDATION

## WHAT ARE THE CONCERNS?

### ALIGNMENT OF INCENTIVES

- GPs: AUM growth and product proliferation
- LPs: Investment performance and fees

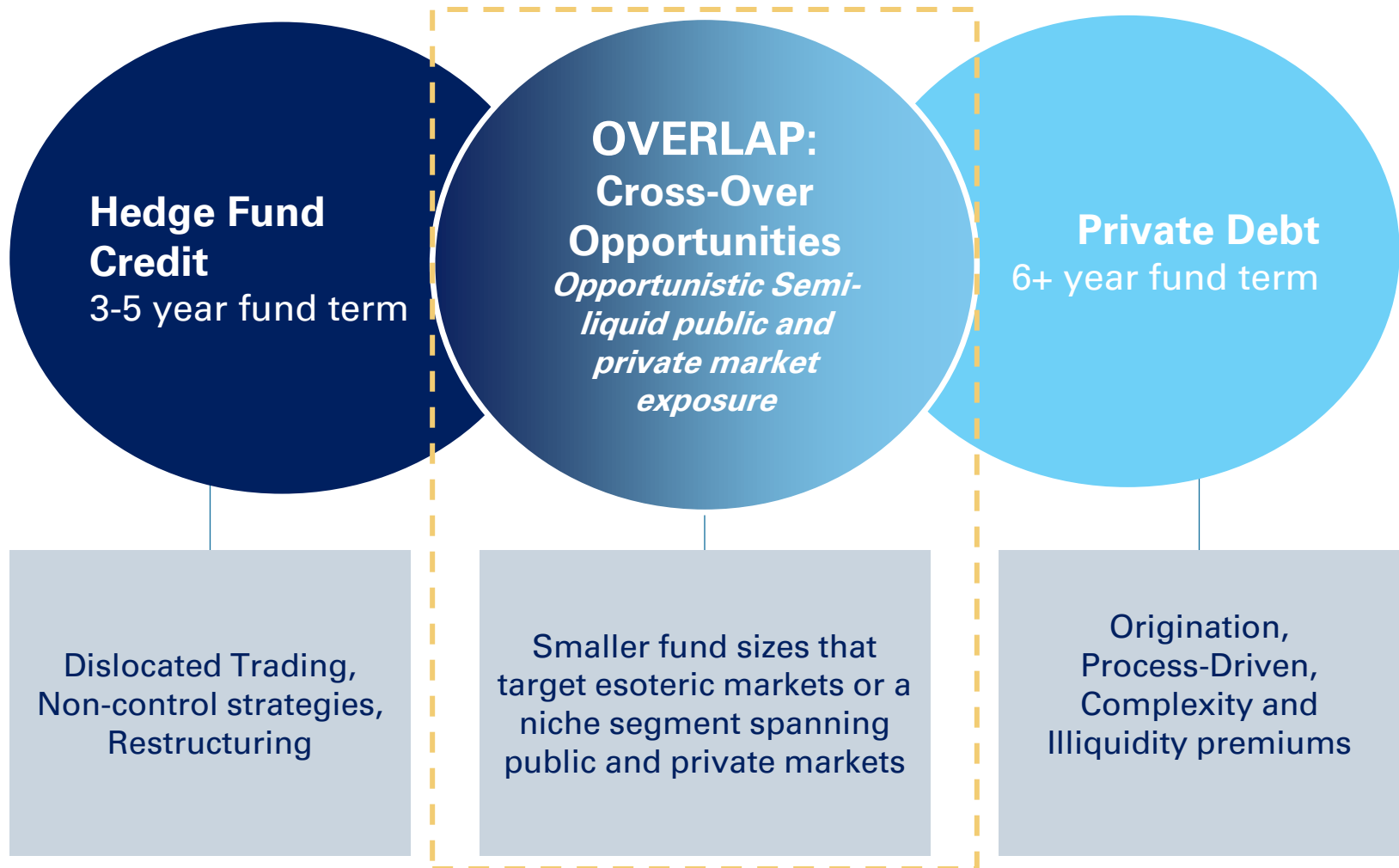
### HUMAN CAPITAL

- Distracted from deployment/monitoring
- Talent exiting the firm

### PERFORMANCE DETERIORATION

- Maintaining discipline
- Adverse selection

# "HYBRID FUNDS"



# OUTLOOK & 2025 THEMES





# 2025 THEME

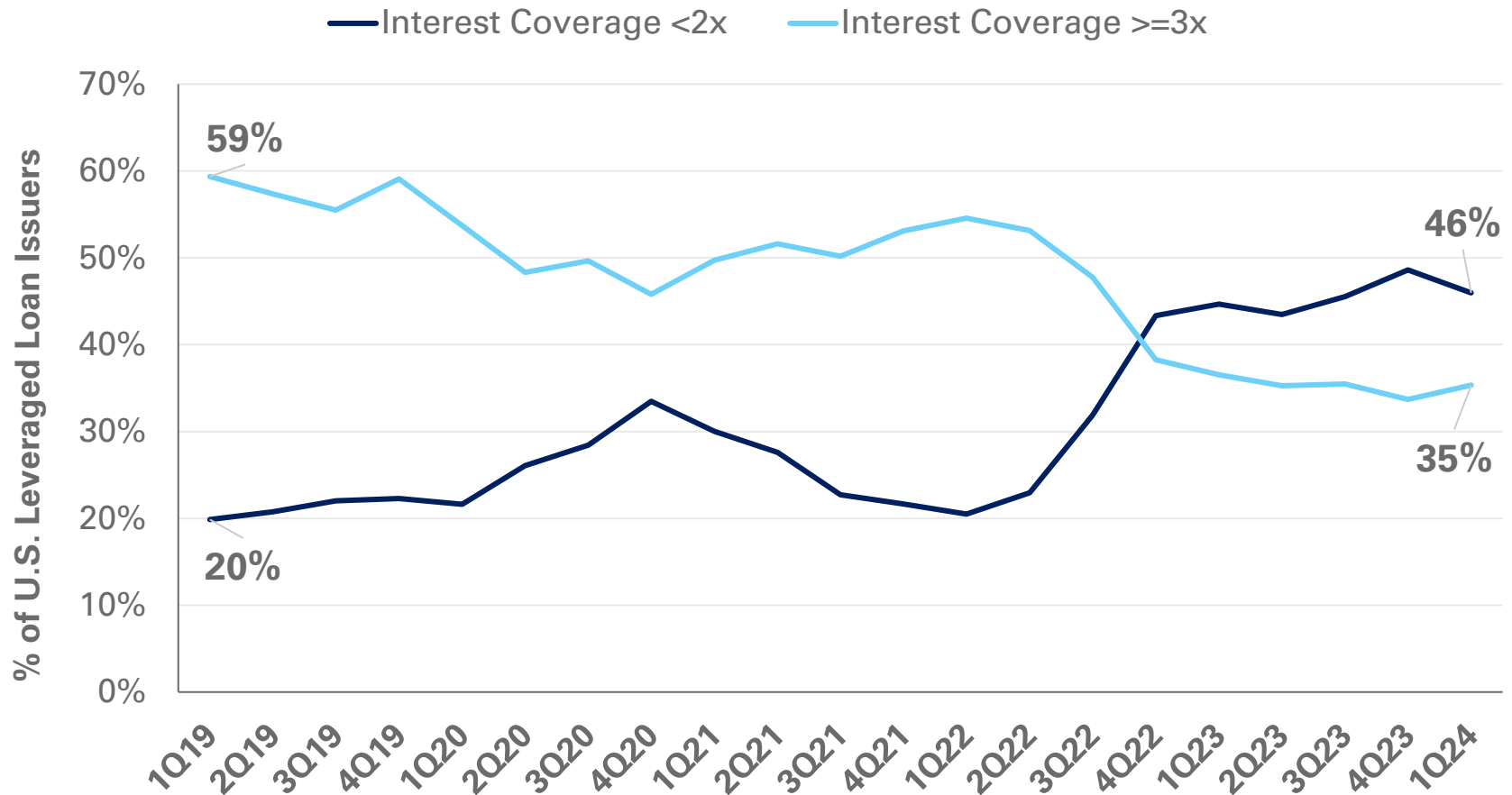
## TRANSITIONAL CAPITAL





# INTEREST COVERAGE ON LEVERAGED LOANS

WORSENING AS RATES REMAIN ELEVATED

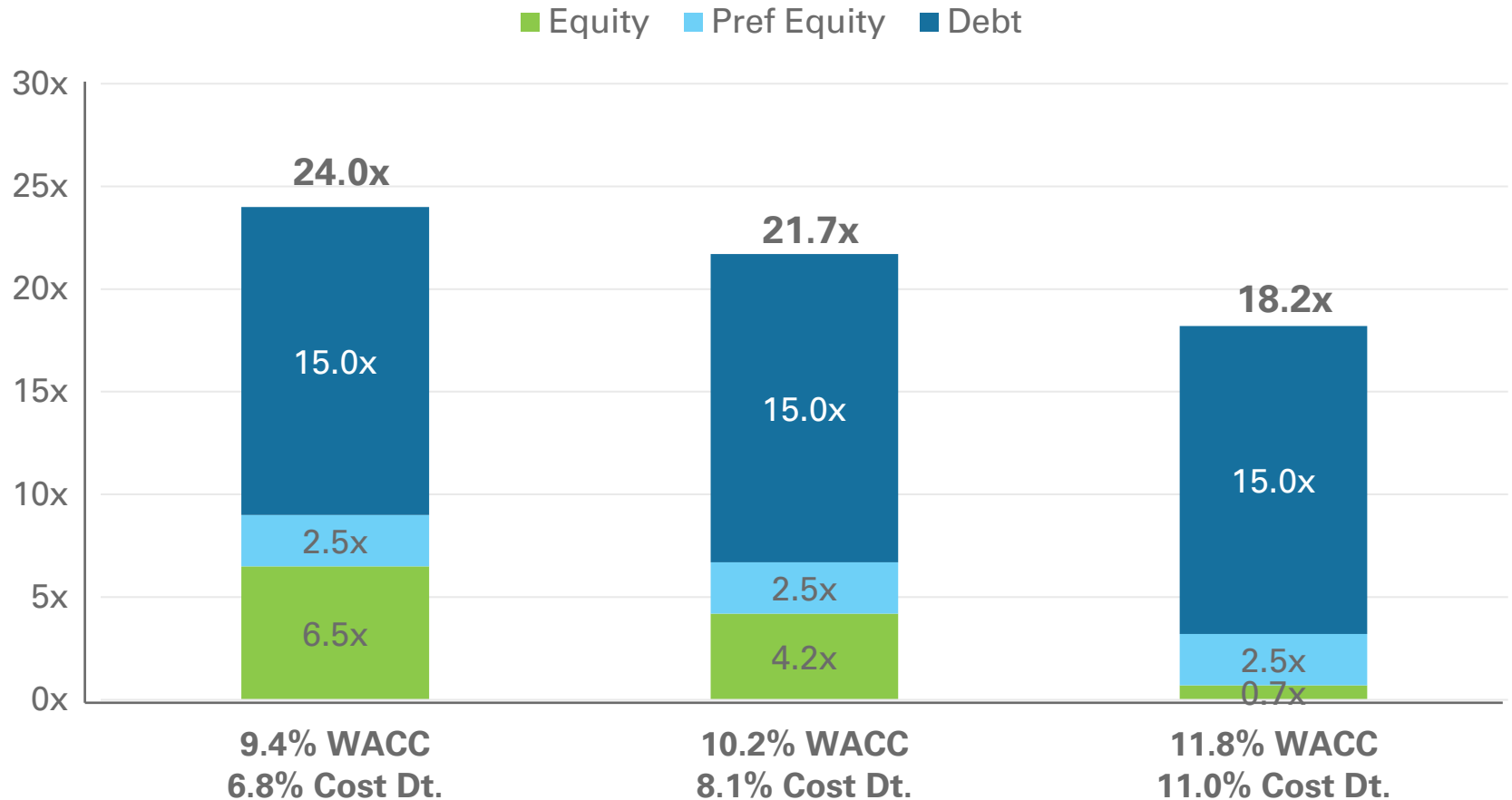


Source: J.P. Morgan, Capital IQ and Bixby Research and Analytics Inc.



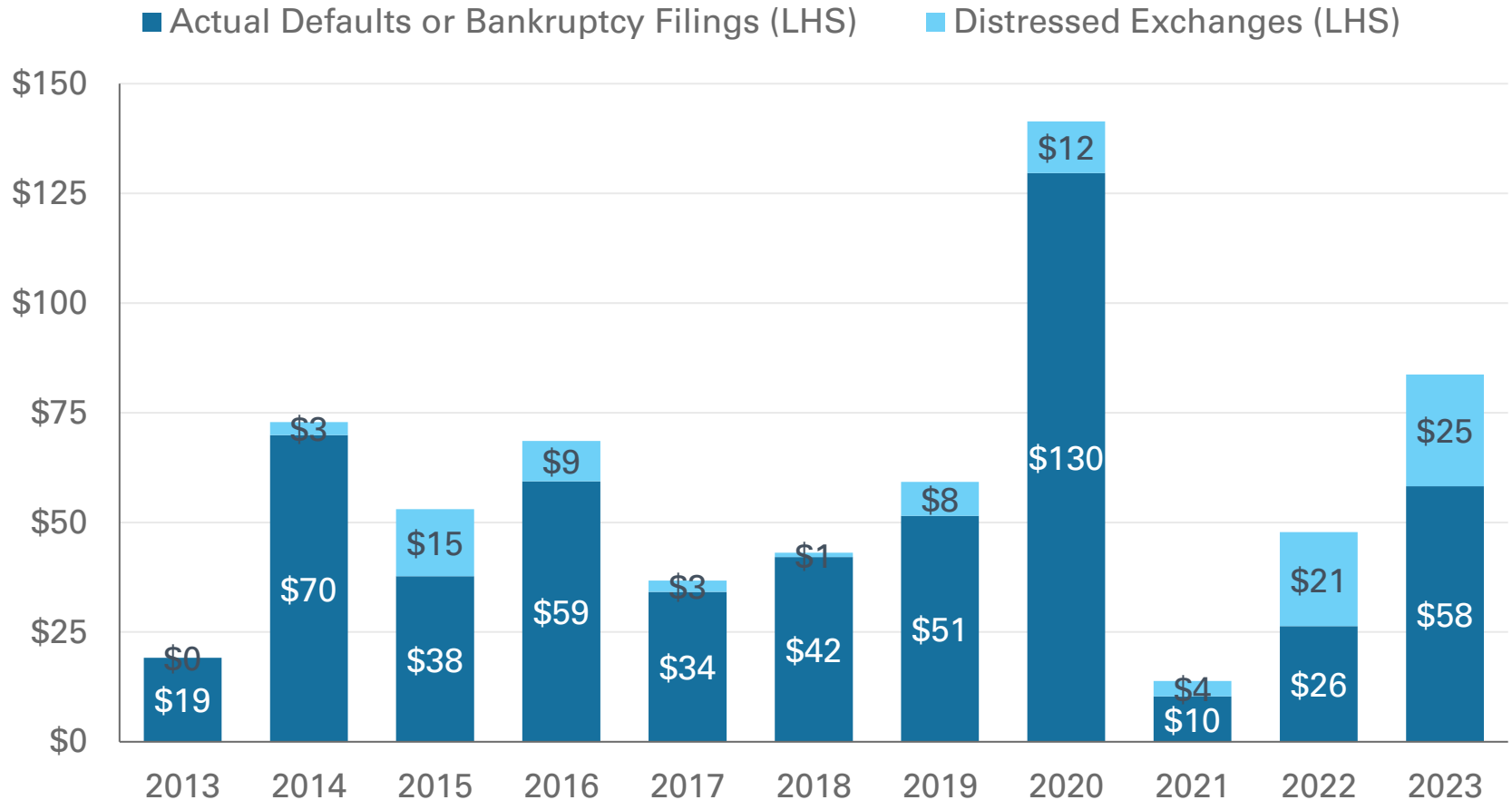
# ENTERPRISE VALUE AT VARIOUS WACC'S

EQUITY VALUES CONTINUE TO GET SQUEEZED



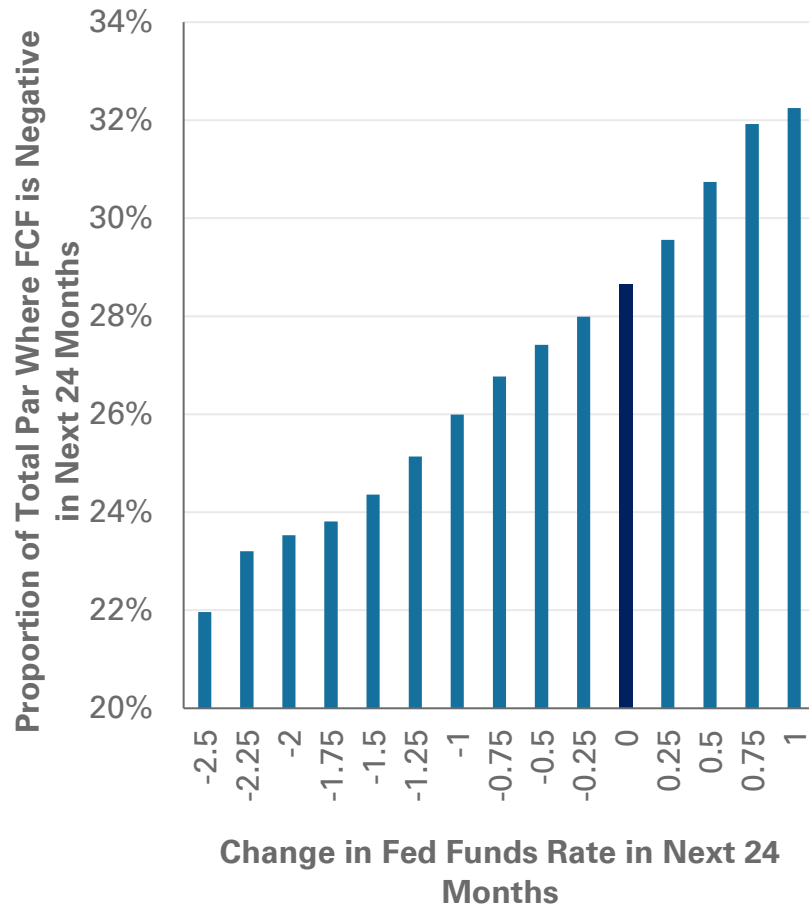
# LIABILITY MANAGEMENT EXERCISES

VOLUME IS INCREASING



# IMPACT OF RATE OUTLOOK

## RATE CUTS WILL NOT UNILATERALLY SOLVE BROKEN CAPITAL STRUCTURES



Interest Coverage Ratios							
Change in Interest Rates							
Change in EBITDA		-200bp	-100bp	-50bp	Current	+50bp	+100bp
	30%	2.8	2.5	2.3	2.2	2.1	2
	20%	2.6	2.3	2.2	2	1.9	1.9
	10%	2.4	2.1	2	1.9	1.8	1.7
	0%	2.1	1.9	1.8	1.7	1.6	1.5
	-10%	1.9	1.7	1.6	1.5	1.5	1.4
	-20%	1.7	1.5	1.4	1.4	1.3	1.2
	-30%	1.5	1.3	1.3	1.2	1.1	1.1

# 2025 THEME

BANK DISPLACEMENT  
CONTINUES...



# BANK DISPLACEMENT CONTINUES...

ASSET-BASED LENDING





# DIFFERENT TYPES OF ASSET-BASED LENDING

## DIRECT ORIGINATION VS. STRUCTURED FINANCE

### Direct Origination

- **Direct loans to corporate borrowers**
  - Usually structured as term loans
- **Primarily incremental liquidity and transition capital**
- **Portfolios typically consist of one pool of diversified, directly-originated loans**

VS.

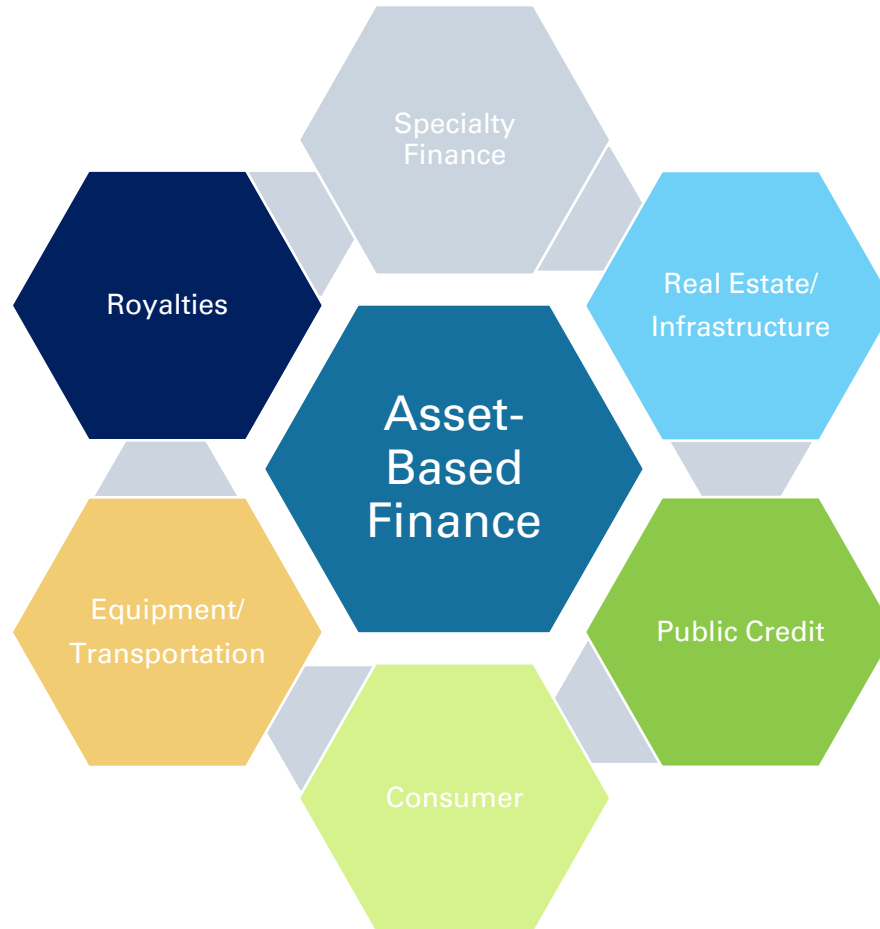
### Structured Finance

- **Structure of purchase of cash flow streams generated by a physical or financial asset**
- **Financing to third-party originators**
- **Loan & lease portfolio acquisitions**
- **Acquisition of origination platforms**
- **Sometimes referred to as asset-backed securitization**

Note: Both investment types may present in ABL funds

# ASSET-BASED LENDING EXPOSURES

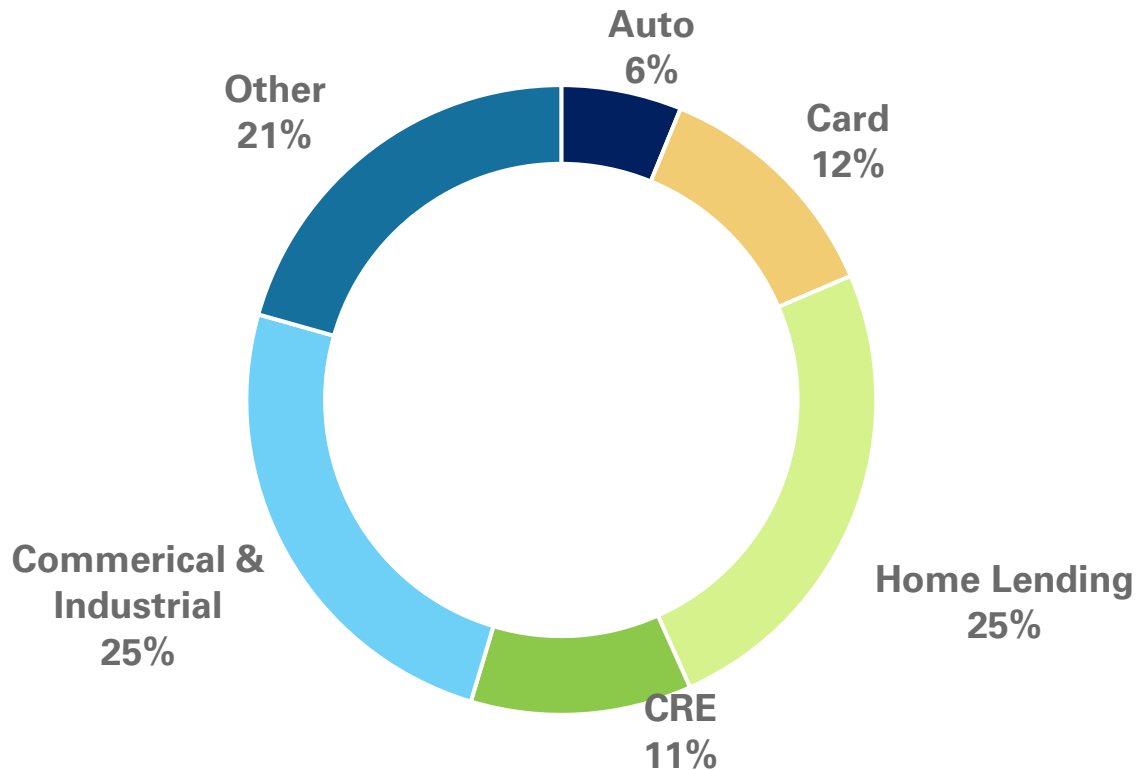
WIDE SPECTRUM OF ASSETS



# BANK BALANCE SHEET COMPOSITION

ASSET-BASED EXPOSURE IS MAJORITY OF HOLDINGS; UP FOR GRABS AS BANKS RETREAT

## Loan Holdings of Small & Regional US Banks (<\$250 billion)



# ASSET-BASED LENDING

## DIVERSIFICATION BENEFITS

	Agency RMBS	CMBX AAA	CMBX BBB	Auto Loan ABS	Credit Card ABS	Student Loan ABS	CDX IG	CDX HY
Agency RMBS	---	0.34	0.89	0.71	0.54	0.57	0.35	0.69
CMBX AAA	0.34	---	0.34	0.46	0.72	0.58	0.74	0.52
CMBX BBB	0.89	0.34	---	0.85	0.59	0.80	0.45	0.81
Auto Loans ABS	0.71	0.46	0.85	---	0.84	0.90	0.65	0.92
Credit Card ABS	0.54	0.72	0.59	0.84	---	0.79	0.70	0.76
Student Loan ABS	0.57	0.58	0.80	0.90	0.79	---	0.76	0.88
CDX IG	0.35	0.74	0.45	0.65	0.70	0.76	---	0.84
CDX HY	0.69	0.52	0.81	0.92	0.76	0.88	0.84	---
Average Correlation	0.58	0.53	0.68	0.76	0.70	0.76	0.64	0.77

Note: Correlations are based on asset-level returns between 1/25/2013 and 01/22/2024.

Source: Bloomberg, Markit, Haver Analytics, ICE-BAML, Goldman Sachs GIR, TPG.

# BANK DISPLACEMENT CONTINUES...

EUROPE



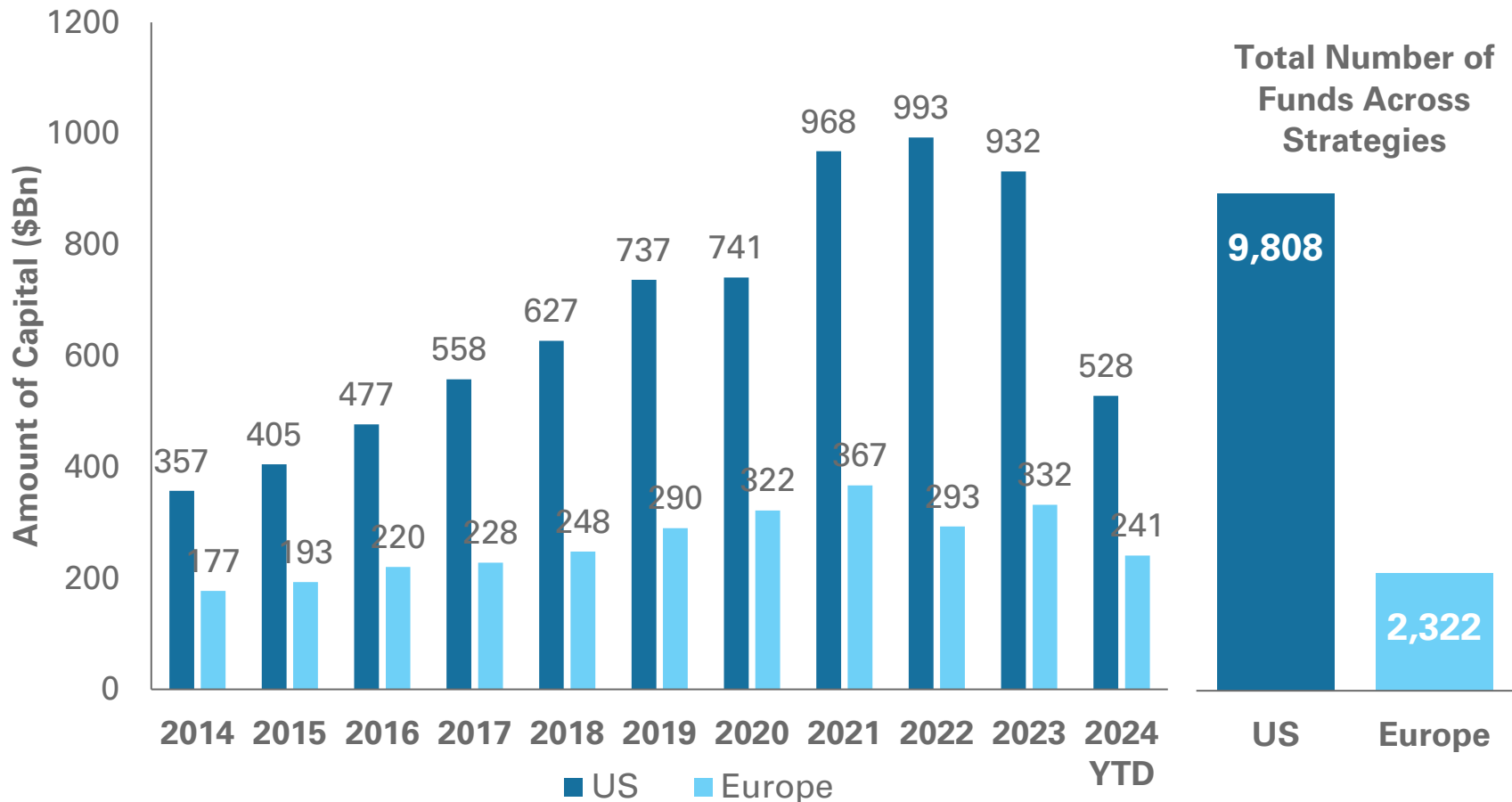
# EUROPEAN BANK RETRENCHMENT

## REASONS

- 1** Larger Existing Exposure to Corporate Lending Relative to U.S. Peers
- 2** Higher Level of Risk Capital Requirements
- 3** Larger Existing Exposure to Commercial Real Estate Relative to U.S. Peers
- 4** Lower Profitability and Valuations Compared to U.S. Peers

# US VS. EUROPE PRIVATE CAPITAL

## LESS PENETRATION AND COMPETITION IN EUROPE





# 2025 THEME

PRIVATE MARKETS  
LIQUIDITY: PORTFOLIO  
FINANCE



# PORTFOLIO FINANCE

	Use of Proceeds	Collateral	Underlying Strategies	Key Lenders
<b>Subscription Lines</b>	Cash Management Acquisition Financing	Uncalled Capital Commitments	All	Banks Insurance
<b>Hybrid Facilities</b>	Cash Management Acquisition Financing Leverage/Fund Recapitalization Return of Capital Alternative to LBO and IPO Support of Portfolio Companies	Uncalled Capital Commitments + Fund Positions	Primarily Buyout	Banks Insurance Asset Managers
<b>NAV Lending</b>	Cash Management Acquisition Financing Leverage/Fund Recapitalization Return of Capital Alternative to LBO and IPO Support of Portfolio Companies	Fund Positions	Primarily Buyout, with increasing activities in Credit, Real Estate, Infrastructure and Venture Capital	Banks Insurance Asset Managers
<b>Credit Secondaries</b>	Cash Management Acquisition Financing Leverage/Fund Recapitalization Return of Capital Alternative to LBO and IPO Support of Portfolio Companies	Diversified Pool of Private Funds	Primarily Buyout, with increasing activities in Credit, Real Estate, Infrastructure and Venture Capital	Banks Insurance Asset Managers
<b>GP Solutions</b>	Fundraising needs Non-dilutive Strategic Capital Raises Leverage for GP Commitments	Management Fees + GP Commitments	All	Asset Managers
<b>CFOs</b>	Regulatory Capital Efficiency Leverage/Recapitalization of Fund Portfolios	One or More Private Funds	All	Insurance Asset Managers

# TAILWINDS FOR INCREASED DEAL ACTIVITY

## LP Portfolio Management

Short-Term Liquidity Needs	Portfolio Rebalancing
Accelerate Distributions	Reduce Unfunded Liabilities

## GP Fund & Asset Level Solutions

Extend Duration to Maximize Asset Value	Maintain AUM base while generating liquidity for LPs
Crystallize Performance	Finance GP Commitment

## Strategic Goals

Change in Investment Mandate	Ownership/Managerial Changes
Generate Dry Powder to Support New Commitments	Relieve Administrative Burden

## Strategic Goals

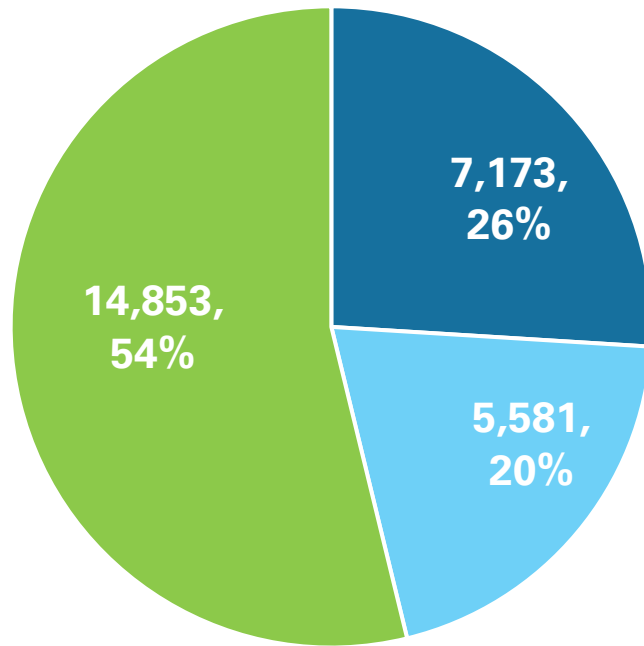
Seek Permanent B/S Capital	Address Succession Planning Concerns
Develop New Product Offerings	Explore Growth Capital Alternatives

# AGING PRIVATE EQUITY ASSETS

## IN NEED OF CREATIVE EXITS OR REFINANCINGS

**Private Equity Assets Have Aged  
(Number of Companies)**

**...Due to Challenged Monetization  
Paths**



■ 6+ Years   ■ 4-6 Years   ■ 0-3 Years

**Sale To  
Financial  
Sponsor**

**Unrealized NAV Draws Dry  
Powder;  
Challenged Financing  
Environment**

**Sale to  
Strategic**

**Regulatory Environment Less  
Hospitable;  
Valuation Expectation  
Mismatches**

**Public Exit**

**Recent IPO's Have Struggled;  
IPO Discounts Creating Valuation  
Gaps**

Source: Pitchbook, 2024 Bain & Company Global Private Equity Report. Excludes add-ons; time in portfolio: "0-3 years" means the investments were made in 2020 and onward, "4-6 years" means the investments were made in 2017-2019, "6+ years" means the investments were made prior to 2017.

# PORTFOLIO FINANCE HIGHLIGHT

CREDIT SECONDARIES



# OVERVIEW

**The emergence of private credit secondaries is part an organic evolution of the asset class.**

1

Secondary transactions typically require **mature portfolios** and/or **periods of market volatility**.

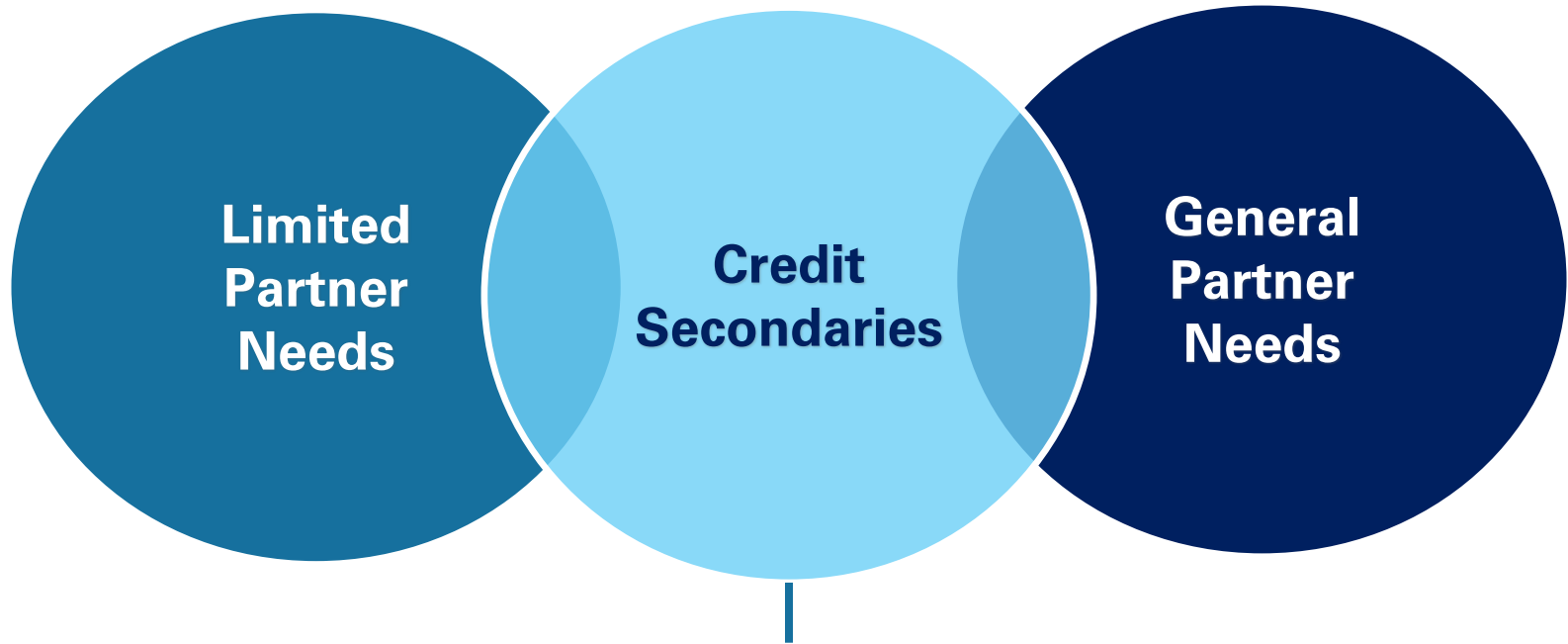
2

These transactions within private credit have been limited because this is a relatively nascent asset class, born out of the GFC, and over that timeframe it has been a relatively benign credit environment (outside of the short-lived COVID volatility).

3

The opportunity set is expected to broaden with the adoption of new and innovative structures/solutions within the space, and deal flow is expected to increase due to several tailwinds.

# ADDRESSING THE MARKET NEED



Limited liquidity for active portfolio management

Unpredictable pace of distributions

Slow reaction to market dislocations

Fluid regulatory environments

Need to rebalance allocations

Difficulty crystallizing returns



# BENEFITS TO INVESTORS

## LP-LED AND GP-LED PRIVATE CREDIT SECONDARIES



# BEST PRACTICES



# PRIVATE MARKETS INVESTING

## BEST PRACTICES



Strategic targets are encouraged but don't be dogmatic



Pacing plans are a critical portfolio management and risk management tool



Private markets are long-term investments and should not be used express tactical investment views



Re-up with strong managers



Ensure overall asset allocation has enough true liquidity to meet calls and spending



If you are early in your private markets investment journey, or building out a larger allocation, know that it will take time

# APPENDIX



# VEHICLE STRUCTURE PROLIFERATION




## COMMON OFFERINGS

Vehicle Structure	Definition	Suitability
<b>Closed-End</b>	Vehicles with finite committed capital, investment periods and overall fund terms	For investors that prefer clarity around capital deployment and distribution timelines
<b>Evergreen</b>	Open-ended vehicles allowing for continuous capital raising with no fund term explicitly stated	For investors prioritizing ongoing exposure to underlying investments or those seeking to limit the administrative burden of making frequent fund commitments
<b>Rated-Note</b>	Vehicles issue debt securities (notes) that are rated by credit rating agencies based on the quality of the underlying portfolio and the structure of the vehicle	For investors subject to regulatory capital charges on assets (ex. insurance companies)
<b>ERISA Fiduciary/QPAM</b>	Vehicles where the GP assumes heightened responsibilities and legal obligations under the Employee Retirement Income Security Act of 1974	For investors subject to ERISA regulations (ex. Taft-Hartley or corporate pensions)

# BROADLY SYNDICATED LOANS VS. MIDDLE MARKET

Exhibit A: Page 52

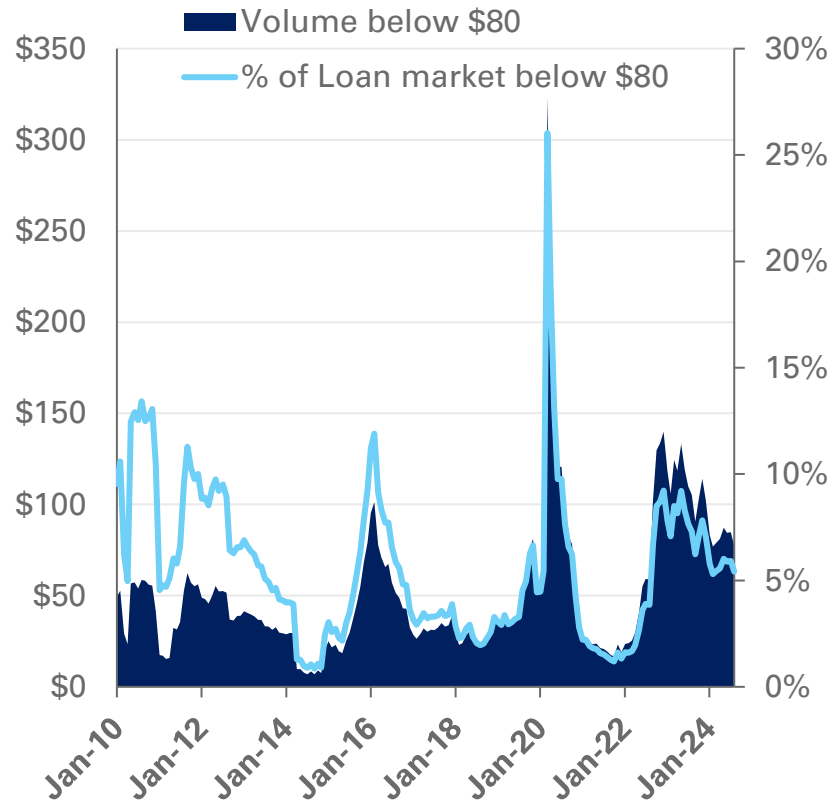
BEWARE OF CONCENTRATION AT THE LARGER END OF THE MARKET...

	Power-School	Catalent	Adevinta	Ardonagh	PDI	Hyland	BradyIFS	Baxter	Cotiviti	Coupa	Avalara	Zendesk	Kaseya
	\$3.2b	\$4.8b	\$4.9b	\$3.3b	\$1.3b	\$3.4b	\$2.7b	\$2.0b	\$5.5b	\$2.6b	\$2.8b	\$5.0b	\$3.7b
 Antares Capital		X		X	X		X	X					
APOLLO		X	X						X	X	X	X	
 ARES	X	X		X	X	X	X	X	X	X	X	X	X
 Blackstone	X	X	X		X		X	X	X	X		X	X
 BLUE OWL	X	X	X	X	X	X	X	X	X	X	X	X	X
 GOLUB CAPITAL	X	X			X	X	X			X	X	X	X
 HPS	X	X		X				X	X	X	X	X	

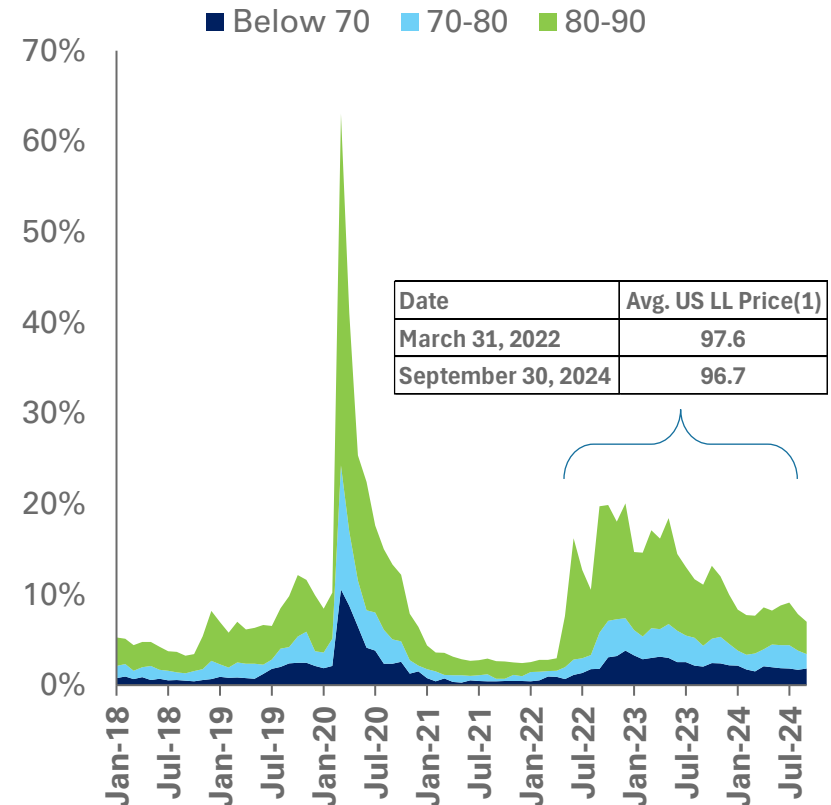
Source: Sources: Bloomberg; Direct Lending Deals, a publication of Capital Stack Publishing, LLC; LSEG; 9fin; Pitchbook, Leveraged Commentary & Data (LCD). Does not necessarily represent complete lender group for any transaction.

# DISPERSION IN CORPORATES

## Loan Market Trading Below 80 and Loan Prices



## Percentage of the Loan Market Trading Below 90



Source: LCD Pitchbook as of September 2024.

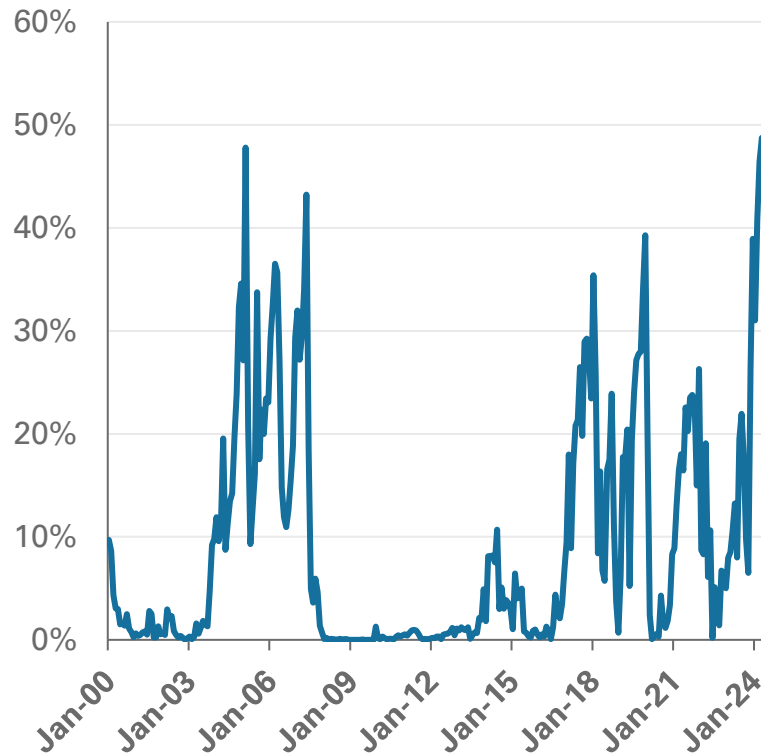
1. Weighted average bid price of US Leveraged Loans.
2. Loan Market Data below \$80 is as of August 31, 2024. Volume is in billions.



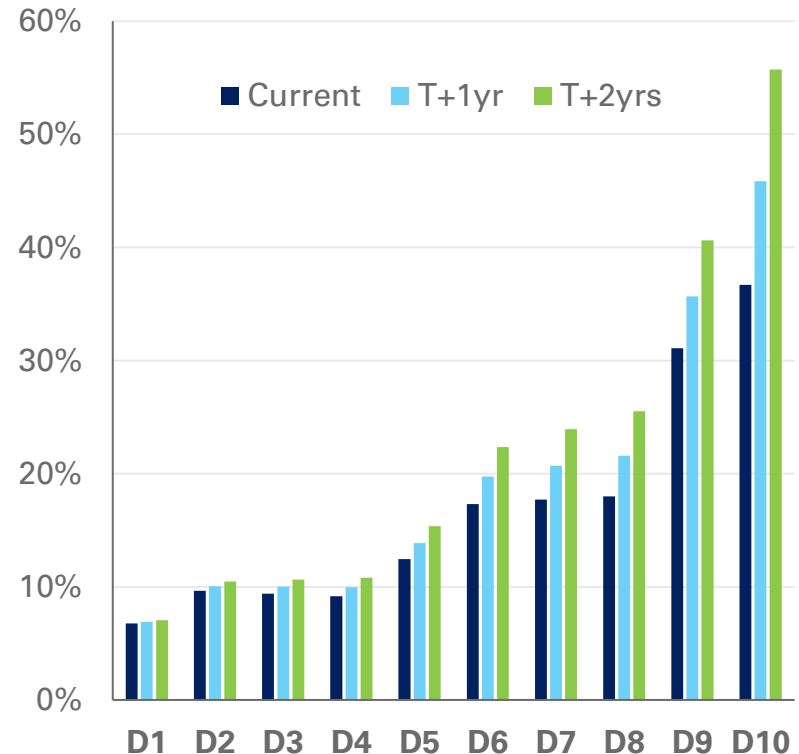
# BIFURCATION IN THE MARKET

MARKET DIVIDED BY THE “HAVES” AND “HAVE NOTS”

**High Yield Bonds Trading <200 bps Spread**  
(Percent of Face Value)



**FCF-Negative Issuers by Quality Decile**  
(Percent of Face Value)



# ASSET-BASED LENDING VS. TRADITIONAL DIRECT LENDING

Exhibit A, Page 55

## HOW IS ABL DIFFERENT?

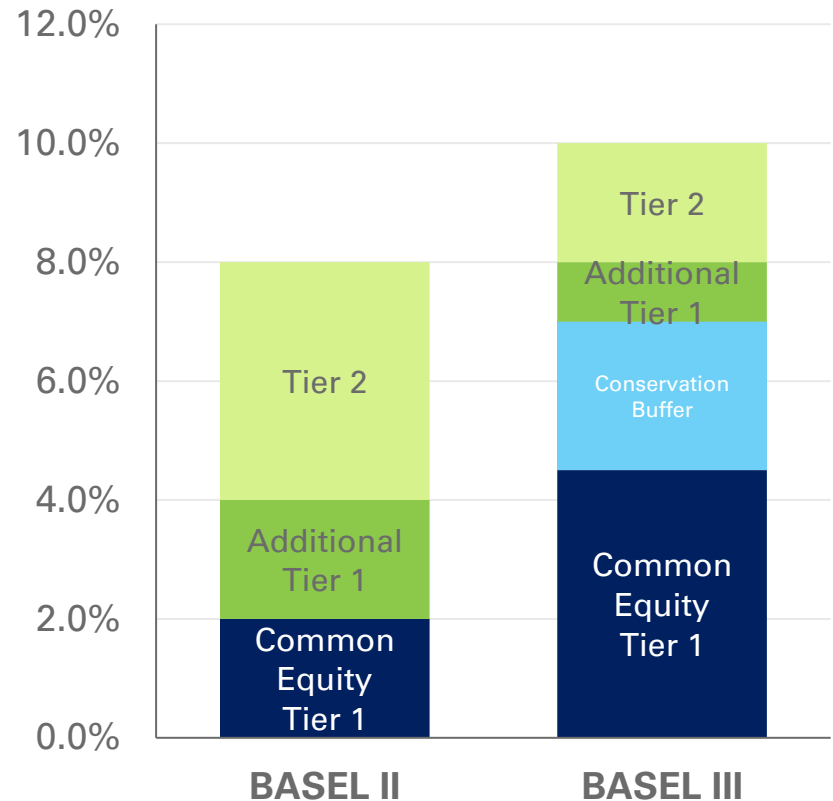
	Asset-Based Lending	Traditional Direct Lending (Cash Flow/Enterprise Value Lending)
<b>Collateral Base for Loan</b>	Borrower's assets (e.g., PP&E, inventory, accounts receivable, etc.)	Borrower's enterprise value generally predicated on its ability to generate future cash flow
<b>Basis for Determining Borrowing Capacity</b>	A percentage of the value of various assets or loan-to-value (LTV) which is regularly monitored and modified	Multiple of borrower's cash flow/EBITDA which is set at the initiation of the loan
<b>Repayment</b>	Loans are typically self-amortizing over time	Loans are largely bullet repayment at maturity
<b>Ability to Achieve Full Loan Recovery</b>	Independent of borrower's performance	Dependent on borrower's performance and health of credit markets to refinance
<b>Return Drivers</b>	Principal, interest and fees, and the monetization of borrower's assets if in default	Principal, interest and fees
<b>Competition</b>	More of a niche market; less dedicated firms and funds	Represents a majority share of the U.S. small to mid sized corporate loan market

# BASEL II VS. BASEL III

## ADDITIONAL CONSTRAINTS FOR BANKS

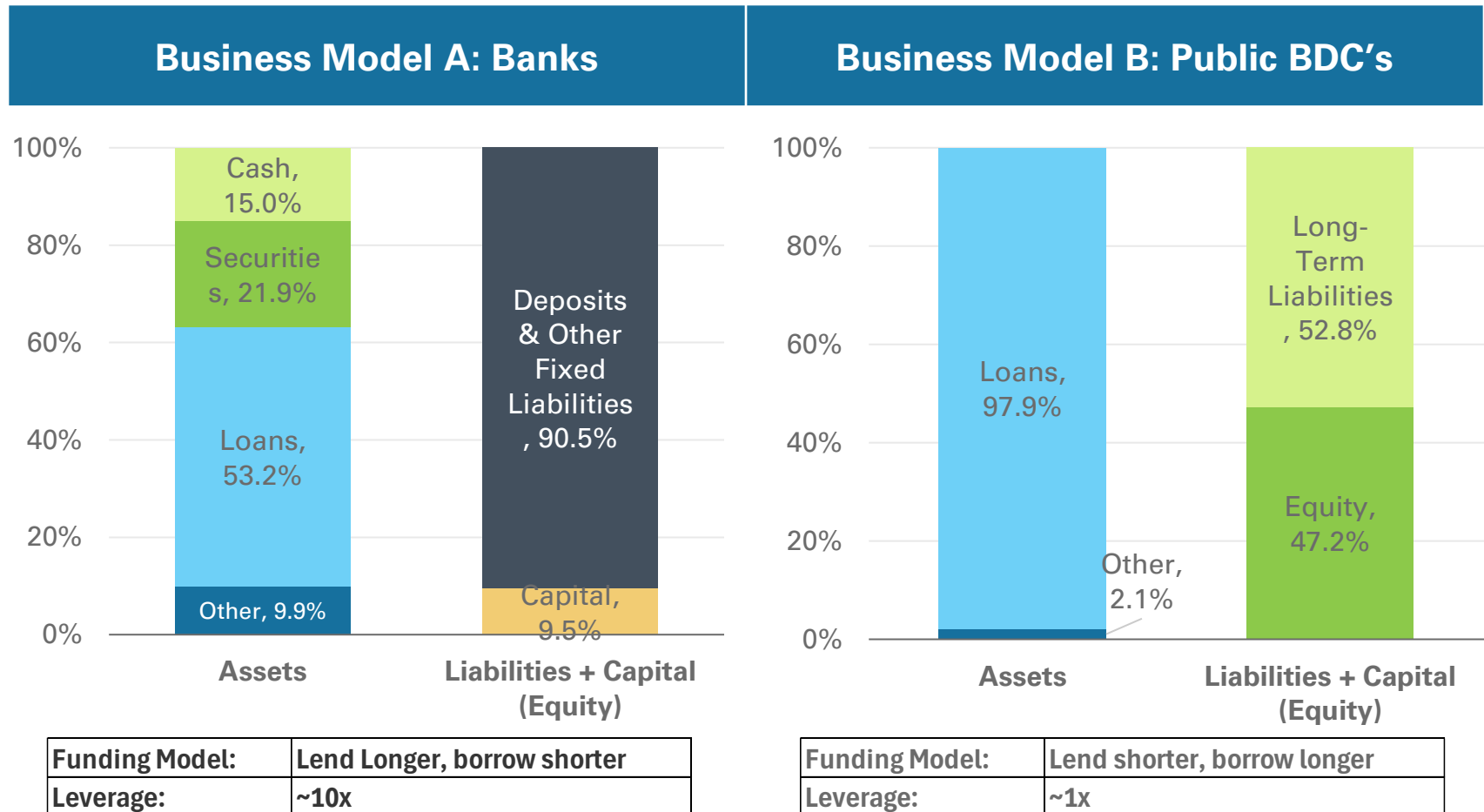
Minimum Capital Requirements	BASEL II	BASEL III
Common Equity Tier 1	N/A	4.5%
Minimum Tier 1 Capital	4.0%	6.0%
Minimum Total Capital	8.0%	8.0%
Leverage Ratio	None	4.0%
Supplemental Leverage Ratio	None	3.0%
Capital Conservation Buffer	None	2.5%
Counter Cyclical Buffer	None	0% to 2.5%
Liquidity Requirements	None	Liquidity Coverage Ratio Net Stable Funding Ratio

Basel II vs Basel III Capital Requirements



# BUSINESS MODEL COMPARISON

## INEFFICIENCY OF BANK MODEL



# NEPC DISCLOSURES

Past performance is no guarantee of future results.

All investments carry some level of risk. Diversification and other asset allocation techniques do not ensure profit or protect against losses.

Some of the information presented herein has been obtained from external sources NEPC believes to be reliable. While NEPC has exercised reasonable professional care in preparing this content, we cannot guarantee the accuracy of all source information contained within.

The opinions presented herein represent the good faith views of NEPC as of the publication date and are subject to change at any time.

This presentation contains summary information regarding the investment management approaches described herein but is not a complete description of the investment objectives, portfolio management and research that supports these approaches. This analysis does not constitute a recommendation to implement any of the aforementioned approaches.

# ALTERNATIVE INVESTMENT DISCLOSURES

It is important that investors understand the following characteristics of non-traditional investment strategies including hedge funds and private equity:

1. Performance can be volatile and investors could lose all or a substantial portion of their investment
2. Leverage and other speculative practices may increase the risk of loss
3. Past performance may be revised due to the revaluation of investments
4. These investments can be illiquid, and investors may be subject to lock-ups or lengthy redemption terms
5. A secondary market may not be available for all funds, and any sales that occur may take place at a discount to value
6. These funds are not subject to the same regulatory requirements as registered investment vehicles
7. Managers may not be required to provide periodic pricing or valuation information to investors
8. These funds may have complex tax structures and delays in distributing important tax information
9. These funds often charge high fees
10. Investment agreements often give the manager authority to trade in securities, markets or currencies that are not within the manager's realm of expertise or contemplated investment strategy

**THANK YOU**

