FPPTA®

FLORIDA PUBLIC PENSION TRUSTEES ASSOCIATION

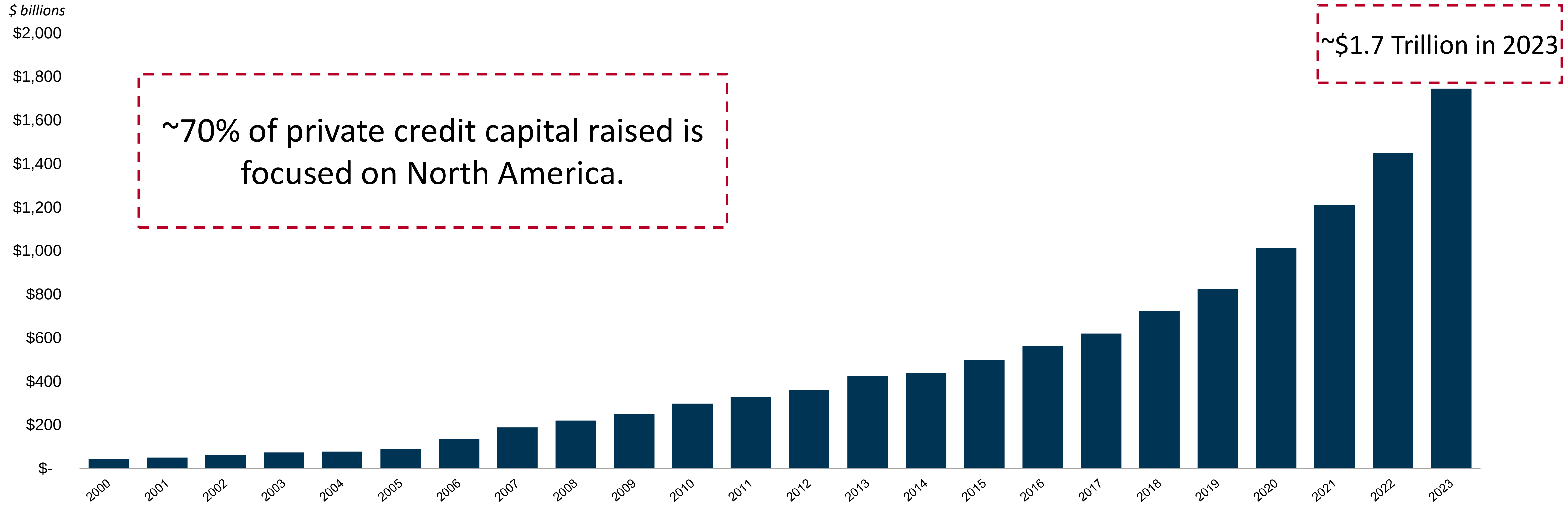
SINCE 1984

CEU Exchange Learning: Understanding Private Markets

Private Credit Continues to Grow with Capital Inflows Going Primarily to Larger Private Credit Managers

- The majority of investors are acquiring their private credit exposure through funds offered by large asset managers focused on larger companies due to resource efficiencies to deploy large amounts of capital.
- In 2023, 65% of private credit commitments were to the 25 largest funds closed during the year. [1]
  - As of Q1 2024, 75% of private credit commitments have gone to the largest 10 funds closed during the quarter. [2]

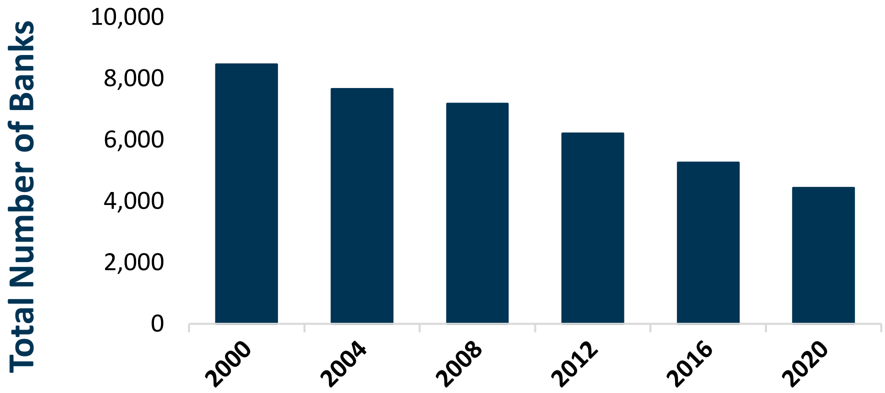
Total Global Private Credit Market Growth since 2000 [3]



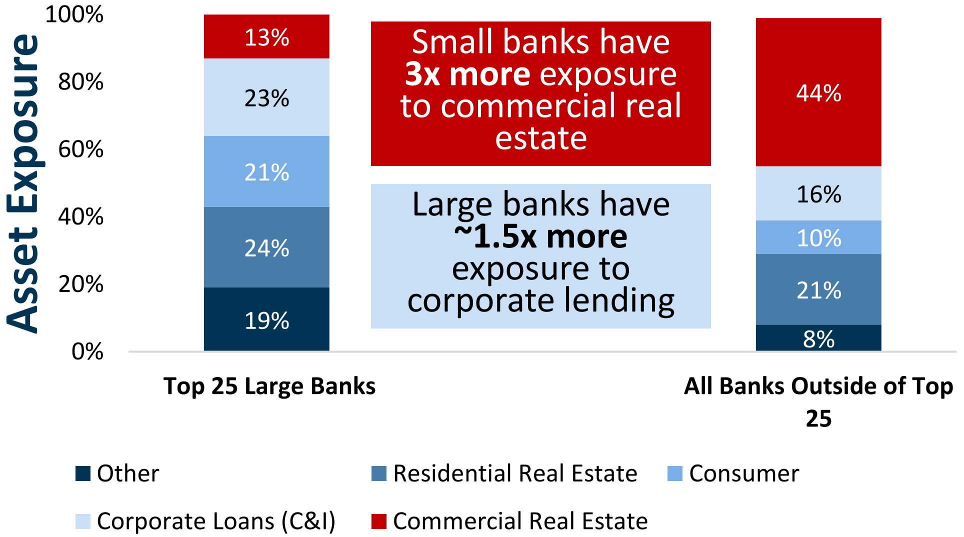
1) Preqin Historical Fundraising. July 3, 2024. **2)** Global Pitchbook Q1 2024 Global Private Market Fundraising Report. May 22, 2024. **3)** Preqin. August 9, 2024.

Why Less Competition Exists in U.S. Lower Middle-Market Lending

Number of U.S. Commercial Banks Have Declined ~50% [1]



Smaller Banks with Limited Capital & Resources Lend More in Real Estate and Less in Corporate Loans [2]



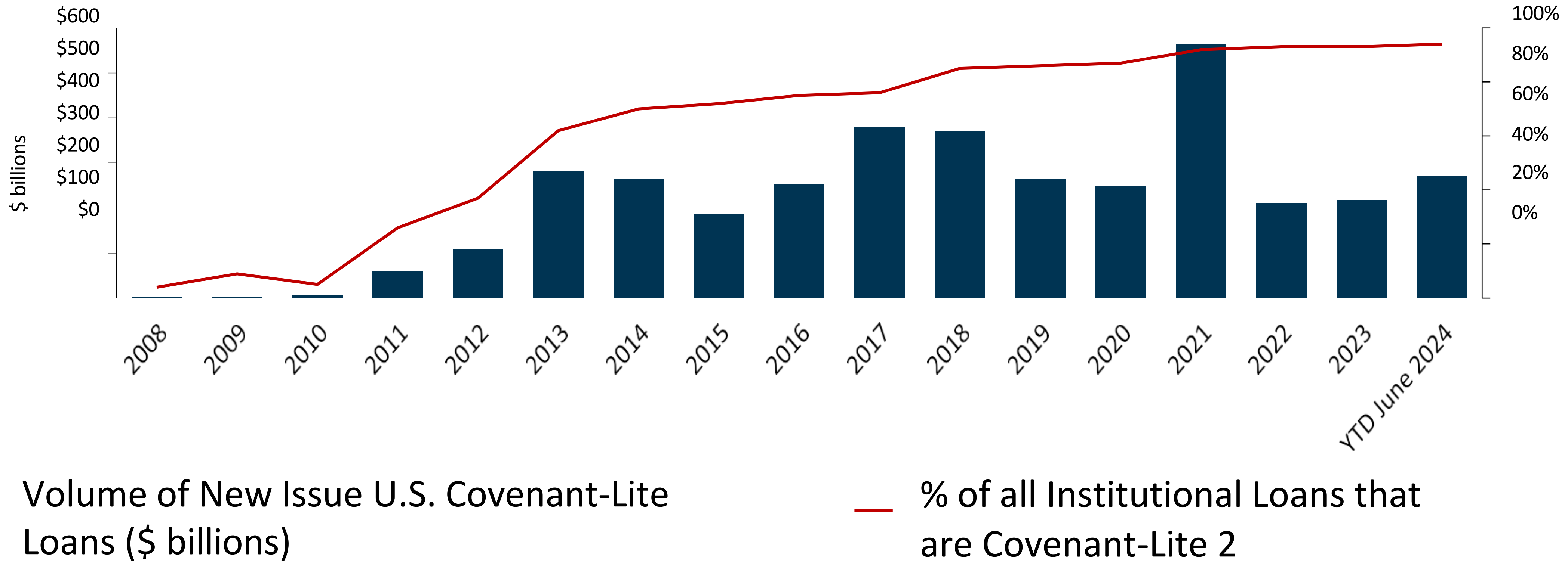
Limited capital availability due to:

1. Fewer market making investment banks service small transactions.
2. Larger asset managers need to deploy more into bigger investments due to large pools of capital they have raised.
3. Larger banks are less interested due to limited ancillary value from investment banking fees, less deposits and more labor intensive.
4. Regional banks are capital constrained and often have less business analysis capabilities to underwrite a broad range of companies.

1) Federal Reserve Economic Data on Commercial Banks in the United States, https://fred.stlouisfed.org/series/USNUM. **2)** JPMorgan Asset Management, Q4 2023 Guide to the Markets. Bank asset exposure is based on monthly H.8 report by the Federal Reserve. Large banks are defined as the top 25 domestically charted commercial banks ranked by domestic assets while small banks are defined as all other domestically charted commercial banks.

Unlike the Proliferation of Covenant-Lite Loans in the Larger, More Competitive Markets, the Lower Middle-Market Maintains Strong

- Since 2008, less protective limited loan covenants (“covenant-lite”) has increased from ~5% to ~95%. [1]

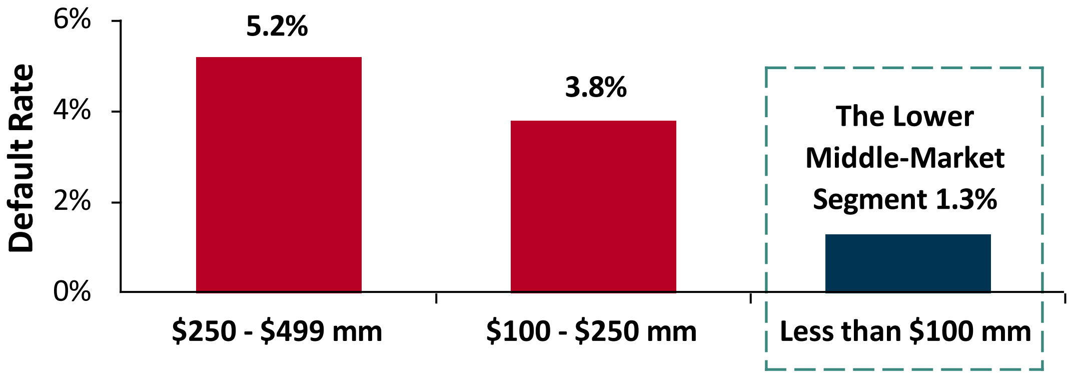


1) Pitchbook. LCD. U.S. Leveraged Loan Quarterly Trend Lines. Q2 2024. Excludes existing tranches of add-ons, amendments & restatements with no new money, as well as DIPs, second liens and unsecured transactions. These numbers comprise loans denominated in all currencies, converted to USD, and are subject to revision as LCD collects additional data. **2)** Institutional loans consist of term loans structured specifically for institutional investors, including CLOs. These tranches include first- and second-lien loans, as well as prefunded letters of credit. The dataset includes all leveraged loans syndicated in the U.S., including USD-denominated tranches of borrowers domiciled in Europe and other locations.

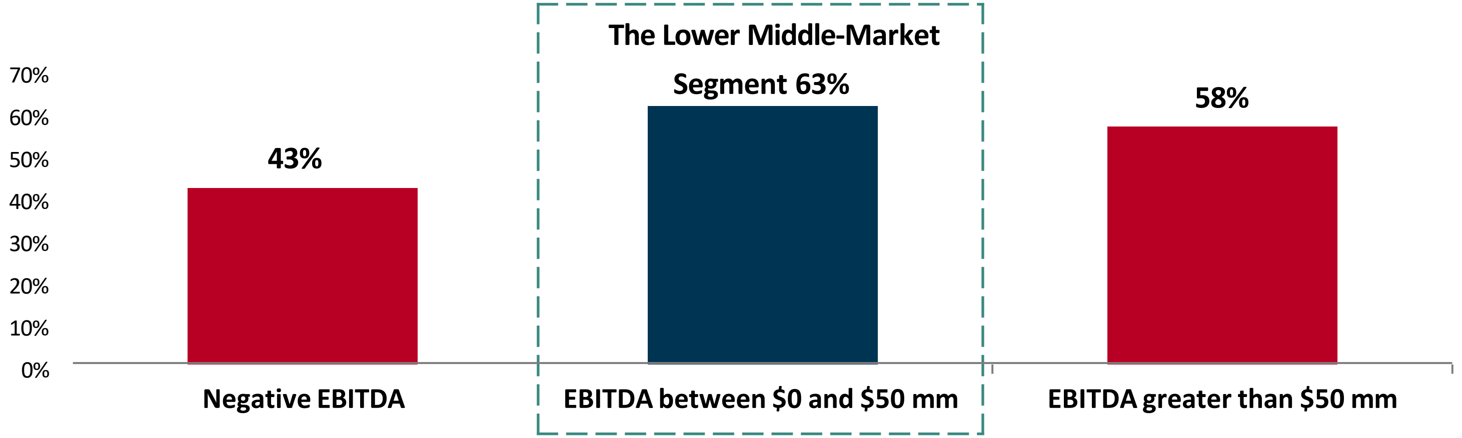
The Lower Middle-Market Segment has Lower Default Rates & Better Historical Recovery Rates

Smaller Loans Have a 75% Lower Default Rate than Larger Loans

PitchBook data from 1995 to 2023 found that smaller loans had a **4x lower default rate** than larger loans. [1]



Average Recovery Rates by EBITDA (1987-2023) [2]



1) Pitchbook LCD Institutional Loan Default Review; comprises loans closed between 1995 and 2022. Independent axis labels reflect loan amount ranges. The dataset includes 1,256 loans of size less than $100 mm, 3,182 loans of size $100 - $249 mm and 3,432 loans of size $250 - $499 mm. This dataset does not represent the total universe of these sized loans. **2)** Pitchbook LCD, S&P, J.P. Morgan Asset Management. May 31, 2024.

Private Credit Considerations and Important Questions to Ask

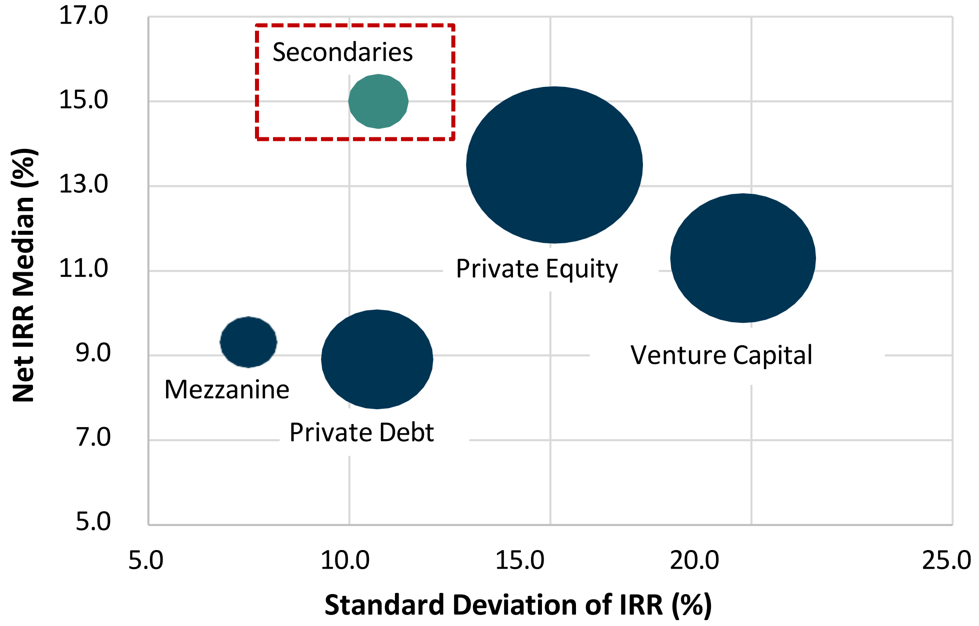
- **Can you invest in different parts of the capital structure?**
- **Why does a borrower come to you?**
- **How do you think about the use of leverage?**
- **What is your risk-return profile vs. peers?**
- **How important are covenants?**
- **What happens when something goes wrong?**
- **How do you take credit impairments on underperforming assets?**
- **Can I see a credit memorandum?**
- **What is your track record through a credit cycle?**
- **How robust are the credit underwriting memorandums and investment committee processes?**

Secondaries Funds Have Historically Offered Best in Class Risk Adjusted Returns

- Secondaries funds have produced a 15% median return with materially less dispersion amongst fund returns than other strategies. [1, 2]
- Attractive risk-adjusted returns result in a secondaries Sharpe Ratio that is 50%+ higher than private equity and 150%+ higher than venture capital, both of which have historically had the highest dispersion of returns.

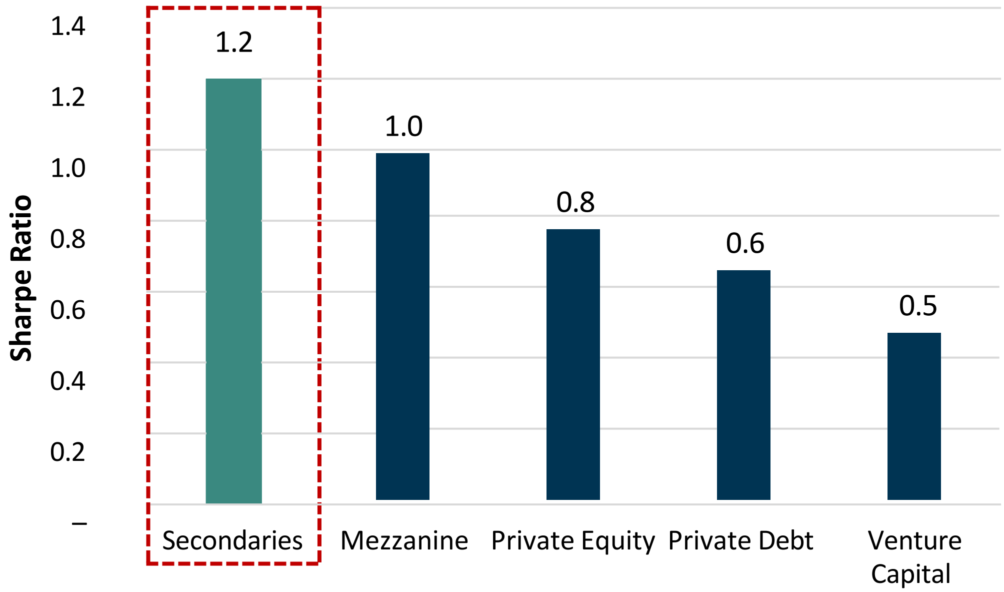
IRR Median & Standard Deviation Of Strategies (Bubble Size = Fund Count) [2]

(Funds with Vintages from 2000-2017)



Sharpe Ratio By Strategy [2, 3]

(Funds with Vintages from 2000-2017)

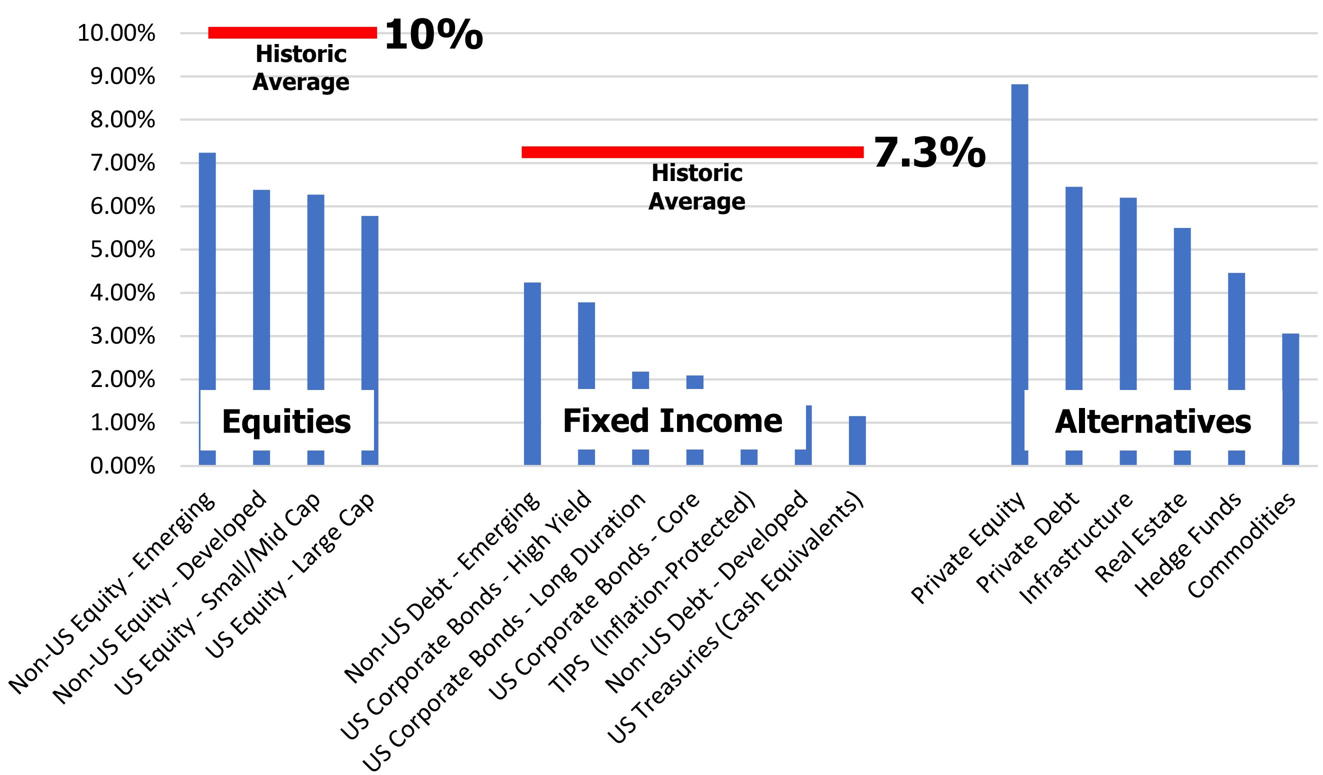


1) Marking to market a purchase price typically discount at entry results in high IRRs in the early life of a secondary fund. For this reason, Star Mountain compares returns for mature funds. 2017 sample end date for data pulled in November 2023 would imply that the youngest funds in the sample are 5-6 years old. **2)** PitchBook, December 2023. Sample includes funds with vintages 2000 – 2017; 146 secondaries funds, 1,897 private equity funds, 764 private debt funds, 203 mezzanine funds and 1,289 venture capital funds. **3)** Sharpe Defined as (Median IRR - Risk Free Rate of 2%) / Standard Deviation of Sample Returns.

Why Alternatives?

Because the general belief is that it will be harder to meet return assumptions in the future using traditional equity and fixed income allocations.

Why Alternatives?



To potentially enhance future returns by embracing different types of risk.

Source: 2021 Horizon Actuarial Services—Capital Markets Survey, Average Expected Return—10-year horizon
This contains forward-looking statements which may be subject to various uncertainties whereby the actual outcomes or results could differ from those indicated.

Alternative Investments

General Observations and Risks:

- Need access to **best managers** to achieve performance goals.
- Need to take time to understand the **strategy and risks**.
- **Less transparency** than traditional public investment portfolios.
- Must understand **valuation methodology**—Not publicly traded.
- **Less liquidity**—Often provided at the discretion of the manager.
- **Leverage** is often used—Amplifies gains and losses.
- If investing globally, how does manager **assess social, political and legislative risks** which can change the playing field and **hedge currency risk**?
- Fees are **higher**—Need to understand fee structure and magnitude.
- Manager will not always serve as **ERISA fiduciary**.

Use the above to drive questions during investment diligence.