MACKENZIE Investments + Northleaf

Your guide to investing in private credit

Why private credit?

Private credit is a broad asset class that can offer unique benefits to investors. It's a diverse space, with objectives that range from capital preservation and income stability to more aggressive total return strategies. Investors typically choose private credit for its enhanced yield or total return potential, compared to publicly traded bonds. It may also bring considerable diversification benefits to larger multi-asset class portfolios.

An established asset class on the rise

Simply put, private credit is lending to businesses by non-bank institutions. The borrower may require financing for a strategic acquisition, to fund organic growth or to optimize their balance sheet. Most borrowers tend to be private companies, but public companies may also seek private loans.

The borrower may not have access to funding through traditional bank financing or debt markets, or it might prefer to work with a lender able to offer more flexible terms, customized structures and faster loan processing.

In this guide, we'll explore:

01 What is private credit and why is it growing so rapidly?

02 What is an illiquidity premium?

03 What does it take to be a successful private credit manager?

04 What are the key risks associated with private credit investing?

05 What happens when things don't go as planned?

06 What is Mackenzie's view on the future of private credit?

07 What are the key private credit terms to be familiar with?

This form of lending generally serves the "middle market," an important segment of the economy that includes mid-sized companies with established business models and market positions. These companies exist across all sectors of the economy.

They typically generate between $10 million and $150 million in annual earnings before taxes, interest, depreciation and amortization are deducted (EBITDA). These companies are often smaller than those that raise capital through bonds, and are generally not rated by major rating agencies.

The rapid growth of private credit has been driven by two main factors.

1. Regulatory reforms after the great financial crisis have restricted the ability of banks to serve this market. This has led to a funding gap that has been filled by private credit providers.
2. The rapid growth in private equity activity has also fueled the need for creative, flexible and knowledgeable lending partners, which has further contributed to the expansion of private credit.

The relationship between private credit and private equity

- Private equity firms carry out leveraged buyout (LBO) transactions.
- The capital structure of these transactions typically includes debt financing.
- The private equity partners then seek to grow the business, to sell it later at a profit.
- The financing for these transactions is often provided by private credit lenders.

It's important for private credit managers to have a steady pipeline of attractive new lending opportunities, as it helps them maintain a diversified portfolio and deliver competitive risk adjusted returns. Strong relationships with private equity firms can often lead to a greater likelihood of a private credit firm participating in a larger number of attractive deals.

Assets under management in private credit funds has grown from under $50B in 2000 to over $1T in 2020.

GROWTH OF PRIVATE CREDIT AND PRIVATE EQUITY

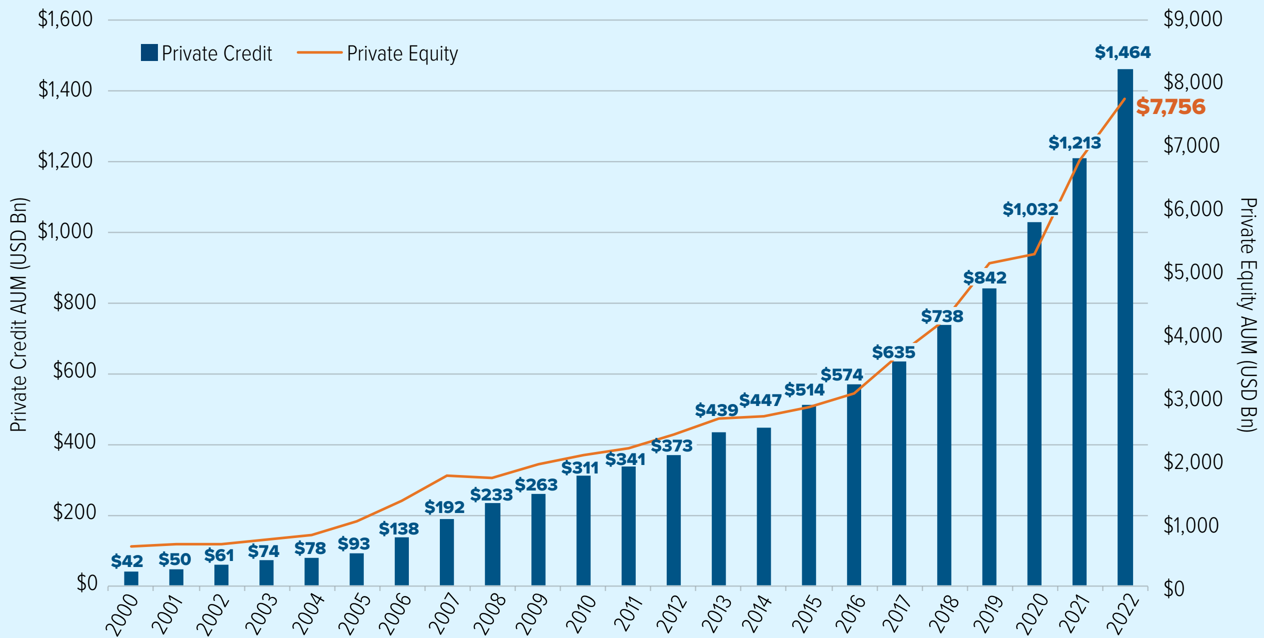

Chart: Private credit has grown from $42 billion in 2000 to $1.464 trillion in 2022. Private equity has grown from about $100 billion in 2000 to $7.756 trillion in 2022.

Source: Preqin: December 2022

The payback for low liquidity is a higher return premium

Once a private loan is made, it's held by either a single lender or a small "club" of lenders, where each member holds a significant share of the loan. These loans are not frequently traded, so the lenders are generally compensated with an "illiquidity premium" — a higher yield than the loan would offer if it was easier to trade. This illiquidity premium may enhance overall returns for investors with longer time horizons.

To accommodate the illiquid nature of private credit assets and ensure the orderly flow of investor capital into and out of these less-liquid securities, private credit funds often offer monthly or quarterly purchase and redemption windows and may come with hard or soft lock-up periods.

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Challenges and opportunities call for specialized expertise

The private credit market is highly decentralized and requires highly specialized analysis to properly understand mid-sized private companies.

This presents both a challenge and an opportunity for private lenders. This is especially true in niche industries where customized debt-financing may only be offered by a small number of lenders.

This can present attractive risk-adjusted return opportunities, due to favourable supply/demand dynamics. The ability to continuously source, screen, select, execute and monitor a sufficiently large pool of private credit deals requires a broad platform, a knowledgeable team and extensive relationships.

There are considerable barriers to becoming a viable provider and manager of private credit. Successful managers can build up significant competitive advantages, and investor due diligence is vital.

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A summary of private credit's key risks

Private credit funds can be structured for a range of risk and return objectives. Potential investors should consider the degree of risk of any given fund along the following dimensions.

Credit risk

This is the likelihood that a borrower will fail to make full and timely payments of interest and principal, and the expected severity of losses should they occur. Because private credit is generally unrated, the onus is on managers of private credit strategies to evaluate companies and debt issues for potential investment. Industry and company factors summarized below offer a view of the potential credit risk in each portfolio or investment strategy, as does target capital structure positioning.

The 4 Cs of credit analysis:

Capacity: A borrower's ability to service its debt can be affected by broad industry structure and risk factors, its profitability and level of existing debt.

Collateral: The quality and value of the borrower's assets that may be sold off in the event of default or borrower bankruptcy.

Covenants: The legal obligations of the borrower are designed to protect creditors. These may include regular interest and principal payments, filing audited financial statements and maintaining certain financial ratios.

Character: The nature and intensions of the company's equity holders, corporate strategy, management team's track record and governance practices.

Capital structure

A company's mix of debt and equity often includes distinct layers, each with its own seniority in the capital structure. The more senior the security, the higher the priority of its claim on company assets in the event of default or bankruptcy. Debt ranks above equity; secured debt ranks above unsecured debt; and senior debt ranks above subordinate (junior) debt.

Higher ranking debt generally receives lower interest rates than lower ranking debt but receives preferred treatment in the event of default or bankruptcy. In some capital structures, specific assets may be pledged as collateral for specific debts. These are referred to as "asset-backed" loans. Secured loans without a specific asset for collateral are referred to as "cashflow" based loans.

Illustration of the capital structure, most senior to most junior: Senior secured debt, junior secured debt, senior unsecured debt, junior unsecured debt, preferred equity, common equity.

Interest rate risk

This is the risk that fixed income securities' prices decline as interest rates rise. Private credit is generally issued with floating rate payments, which adjust up or down with interest rates. This makes private credit less susceptible to losses in rising rate environments than traditional fixed income investments.

Fund level leverage

Some private credit managers use borrowed money to provide additional exposure to private debt beyond their fund's net asset value. This will amplify the risk/return characteristics of an unlevered portfolio and comes with its own borrowing cost.

Valuation practices

Valuation frequency and methodology vary from one private credit fund to the next. These valuation practices can affect the price volatility of private credit funds. Investors should understand the practices of a given private credit manager before investing.

Liquidity

The average expected holding period of loans inside a private credit fund will affect its liquidity profile.

Investors should understand the liquidity characteristics before investing in a private credit strategy, as this will affect their ability to exit their position if they need to.

It can be difficult and/or expensive for a private credit manager to sell a position to raise cash to fund redemptions. It's in the best interest of investors for private credit funds to offer limited and structured redemption terms aligned with the liquidity of the underlying portfolio.

To improve liquidity for investors, some funds will supplement private credit with more liquid forms of fixed income.

When things don't go as planned

Private credit lenders typically benefit from strong legal protection. This is spelled out in the terms, covenants, representations and warranties documented in the credit agreement when the loans are negotiated. This agreement also provides restrictions, visibility and control over the borrower's activity.

If the borrower's business significantly underperforms to the extent that it breaches the credit agreement, the lender and borrower may work to reach a new arrangement. This out-of-court agreement is referred to as a "workout". It may include restructuring the balance sheet, adjusting the terms of the original loan, injecting equity into the business, increasing the lender's claim on the collateral, and/or other measures.

This coordinated activity to resolve an issue often leads to better outcomes for private lenders. Recourse for investors if things don't go as planned ultimately depends on the business prospects and balance sheet quality of the underlying portfolio companies. This underscores the vital importance of deal sourcing, due diligence, transparency, portfolio construction and risk management in the private credit investment process. In a relatively illiquid market where loans do not carry official credit ratings, manager selection is of utmost importance.

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The future of private credit is accessibility

Private credit is generally sought out with the aim of producing better risk-adjusted returns and/or achieving a higher, more sustainable rate of income relative to what can be achieved with publicly traded fixed income. growing demand from investors for these portfolio benefits lead us to believe private credit will only continue to grow in importance as an asset class.

In the past, private markets have been out of reach for average investors, but there is reason to be optimistic about the future democratization of the asset class. Innovation in product design, such as interval funds, make private credit more accessible, with enhanced liquidity and lower investment minimums.

As capital markets continue to evolve, we believe more investors will be able to access the potential benefits of private credit.

> **Innovations in product design, such as interval funds, are making private credit more accessible and easier to implement, by facilitating enhanced liquidity terms, lowering investment minimums and by removing operational hurdles.**

The Mackenzie Northleaf Private Credit Interval Fund is offered to retail investors by way of prospectus, annual information and fund facts. The Mackenzie Northleaf Private Credit Interval Fund is a non-redeemable investment fund in continuous distribution that is structured as an 'interval fund'. Interval funds differ from mutual funds in that investors do not have the right to redeem their units on a regular, frequent basis. The Mackenzie Northleaf Private Credit Interval Fund is only available through IIROC licensed dealers/advisors. An investor should carefully consider whether their financial condition and investment goals are aligned with an investment in the Mackenzie Northleaf Private Credit Interval Fund (the "Fund") . The Fund will invest primarily in (i) illiquid private credit instruments on an indirect basis through investments in one or more Northleaf Private Credit Funds and (ii) public securities and other debt instruments on an indirect basis through investments in exchange traded funds. Due to the illiquid nature of private assets, the Fund is subject to a "ramp-up" period that is expected to last many months meaning exposure to public assets will be higher (and exposure to private assets will be lower) than indicated by any Target Allocation. The legal offering documents contain additional information about the investment objectives and terms and conditions of an investment in the Fund (including fees) and will also contain tax information and risk disclosures that are important to any investment decision regarding the Fund. An investment in the Fund is suitable only for long-term investors who can bear the risks associated with the limited liquidity of the units. An investment in the Fund is not intended as a complete investment program. Investors should consult with their financial advisor to determine the suitability, and appropriate allocation, of the Fund for their portfolio. This document does not constitute legal, tax, investment or any other advice. Prospective investors should consult with their own professional advisors regarding the financial, legal and tax consequences of any investment.

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GLOSSARY

Buyout transactions: The acquisition of a controlling interest in a company.

Capital calls: The transfer of capital committed in advance by investors to a fund. Where they exist, they can take place over a predetermined schedule or at the discretion of the manager.

Cash flow lending: Financing based on the visibility of a company's future earnings and the general health of its balance sheet.

Collateral: An asset pledged as security by a borrower to a lender that will be forfeited in the event of default.

Covenants: Conditions included in a lending agreement that restrict the activities of the borrower.

Credit spread: The difference in yield between a low-risk government fixed income security and another higher-risk fixed-income security with a similar term to maturity but lower credit quality.

Distressed credit: Credit that is in, or soon to be in, default. This also refers to private credit strategies that invest primarily in distressed fixed income securities.

EBITDA: Earnings before interest, taxes, depreciation and amortization – a measure of a company's financial performance.

First lien debt: The most senior class of debt for companies issuing multiple classes.

Gate provision: A statement outlined in a fund's offering documents describing the manager's right to limit or halt redemptions.

Hard lock-up: A minimum holding period before which investor funds cannot be withdrawn from a fund.

Junior debt: Part of a company's capital structure that sits above equity but below senior debt in terms of priority claim on the borrower's future cash flows and collateral in case of default. This also refers to private credit strategies that originate and manage second lien debt and mezzanine financing. Secured junior debt is backed by an asset assured as collateral while unsecured junior debt is not backed by any collateral.

Liquidity: The ease, speed and efficiency with which an asset can be bought or sold at fair value.

Mezzanine financing: Mezzanine securities are those structured with elements of equity and fixed income but always reside above common equity in the capital structure.

Middle market: Companies with proven business models, established market positions and $10-150 million in annual EBITDA.

Opportunistic credit/special situations credit: "Go anywhere" private credit strategies with the ability to deploy capital across the capital structure and credit quality spectrum to harvest returns from rare events.

Private credit: Credit issued by a non-bank entity.

Second lien debt: A class of debt that is subordinate to first lien debt.

Senior debt: The most conservative part of a company's capital structure, with the highest priority claim on the borrower's future cash flows and collateral in case of default. Secured senior debt is backed by an asset assured as collateral while unsecured is not backed by any collateral.

Soft lock-up: A minimum holding period before which investors are charged a fee for withdrawing funds.

Workout: A non-judicial process where creditors and debtors meet to alter the original terms of a loan.