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A Primer on Asset-Based Private Credit

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Table of Contents

I.	What is Private Credit?	3
II.	Direct Lending	3
III.	Asset-Based Private Credit	3
IV.	The Growth of Private Credit	3
V.	Direct Lending vs. Asset-Based Private Credit	5
VI.	The Market Opportunity for Asset-Based Private Credit	6
VII.	The Benefits of Asset-Based Private Credit	7
VIII.	Conclusion	9
IX.	Disclosures	10

I. What is Private Credit?

Private Credit is simply the extension of credit by non-bank financial lenders within the business ecosystem. Private credit may also be called private debt, however, for the purposes of this piece, we will use the term private credit. These non-bank financial lenders are comprised of several different types of capital providers, including private credit funds, hedge funds or large individual investors. Private credit can be used for a variety of purposes, including refinancing existing debt, dividend recapitalizations, funding growth initiatives, financing physical and/or financial assets, or funding acquisitions.

The most common form of private credit is the extension of credit by private funds to corporations[1]. This lending activity is often called **direct lending**. There are generally two forms of direct lending: lending to companies affiliated with a financial sponsor (sponsor-backed direct lending) and lending to companies that are not affiliated with a financial sponsor (non-sponsor-backed direct lending). In typical direct lending transactions, the primary driver of the creditworthiness of the loan is the operating cashflows of the business taking on the debt obligation; and accordingly, direct lending is referred to as a corporate lending product.

In addition to direct lending, there is another form of private credit that is known as asset-based private credit. **Asset-based private credit** is similarly an extension of credit by non-bank financial lenders, but the driver of the repayment activity is the cashflow profile of a discrete, typically cash flowing pool of collateral, as opposed to the cashflows of an operating company. Asset-based private credit is the private version of what the Asset-Backed Securities (ABS) market is to the more liquid fixed income markets.

II. Direct Lending

Direct lending is a type of private credit in which the lender provides financing directly to a corporate borrower in a recourse format. That lending can be secured or unsecured (typically secured) and almost always includes corporate recourse. While a particular direct lender may have a specific security interest in an individual or multiple collateral assets, those same assets are very much part of the borrower's corporate estate. This means that the direct lender likely has a preferred treatment with regards to the specific asset as security collateral in the event of a bankruptcy of the borrower; however, the collateral is still subject to the normal bankruptcy procedures (such as automatic stay provisions). The source of repayment for a direct lending loan is typically the operating and executory cashflows of the business borrowing the money. The specific asset security provided to the direct lender is a credit enhancement for the loan but is generally not the primary source of repayment. One of the most common forms of direct lending is to finance the acquisition of a corporate by a private equity investor and typically is sized as a multiple of earnings before interest, taxes, and depreciation/amortization (EBITDA).

III. Asset-Based Private Credit

Asset-based private credit refers to a type of private credit in which the lender's primary source of repayment is a specific pool of contractual cash flowing assets. In Castlelake's view, this borrowing is most commonly structured in the U.S. in a bankruptcy-remote, non-recourse format to ensure that the collateral being financed is excluded from the bankruptcy estate of the entity looking to raise capital. Asset-based private credit is similar to ABS, which are typically highly structured vehicles with debt securities issued under Rule 144A. Borrowers can use a variety of collateral types to support transactions like these including inventory, accounts receivable, consumer loan contracts, equipment leases or leased real estate. Asset-based credit typically requires specialized expertise and extensive diligence to properly value the underlying collateral.

IV. The Growth of Private Credit

Today the private credit market is $1.4 trillion in size, according to estimates by Bloomberg[2] with the majority of private credit in the form of corporate direct lending[3]. Additionally, the research firm Preqin expects private credit to grow to approximately $2.3 trillion by 2027[4]. A direct result of this market evolution can be seen in the growth of private credit

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[1] Preqin data: Private Debt Funds Assets Under Management, Breakout by Strategy December 31, 2022.

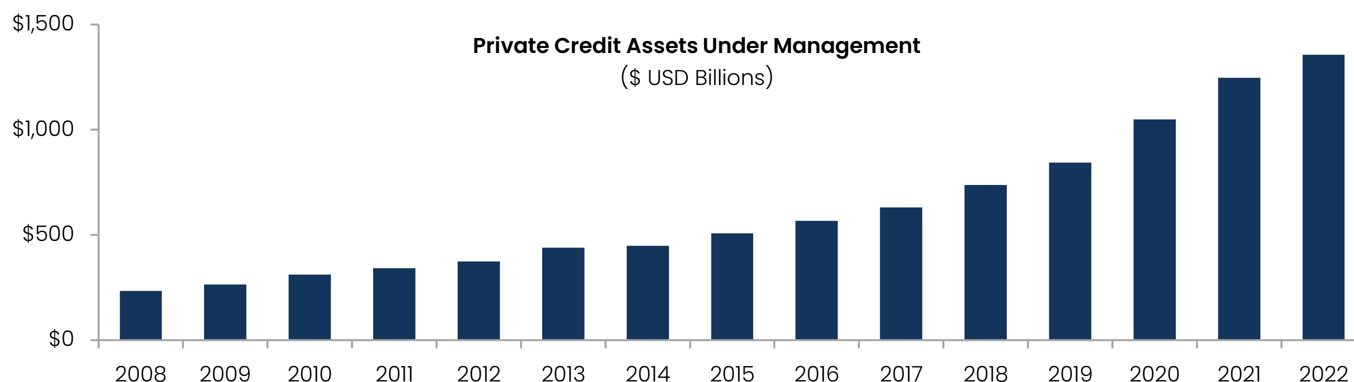
[2] Bloomberg, Private Credit Muscles Out Banks, With Worrisome Consequences, January 13, 2023

[3] Preqin data: Private Debt Funds Assets Under Management, December 31, 2022

[4] Preqin Quarterly Update, Private Debt Q4 2022

assets under management, highlighted in Exhibit 1 below. In Castlelake's view, much of the historical growth of this market has been fueled by the retrenchment of traditional bank capital and an increase in appetite among institutional investors for private credit assets.

EXHIBIT 1: PRIVATE CREDIT ASSETS UNDER MANAGEMENT



Preqin data: Private Debt Funds Assets Under Management, December 31, 2022.

Following the Global Financial Crisis (GFC), Castlelake believes many banks intentionally retreated from lending to certain markets due a number of factors. In Castlelake's view, this system wide shift was driven by, among other things, increased regulation, elevated capital requirements, and tightened underwriting standards.

1. **Regulation[1,2]:** In response to the growth of leveraged lending, regulators issued guidelines that restricted the amount of leverage a regulated bank can provide for leveraged buyouts (LBOs) and other forms of highly leveraged transactions. Under these rules the maximum debt-to-EBITDA ratio for leveraged loans is capped. These rules, often called the SNC (Shared National Credit) rules in the U.S., have, in Castlelake's view, made it very difficult for regulated bank entities in the United States to participate in any transactions with significant amounts of leverage.

2. **Capital Requirements[3,4]:** In response to the GFC, regulators implemented new rules requiring banks to hold more capital to cover potential losses across a wide variety of transaction types. In the U.S., bank regulators limited overall balance sheet leverage. In Europe, regulators changed capital requirements for lending under Basel III and Basel IV. This reduced the amount of capital available for lending, making it more difficult for banks to extend credit to borrowers. In particular, Basel III introduced minimum capital and liquidity requirements that banks had to meet to absorb losses during times of financial stress. Basel IV further strengthens these requirements by introducing new risk-weighted capital standards, an absolute minimum level of required capital and new metrics for measuring liquidity. Overall, Castlelake believes the increased capital requirements have led to a diminished ability for U.S. and European banks to participate in both highly leveraged transactions as well as asset-based finance.

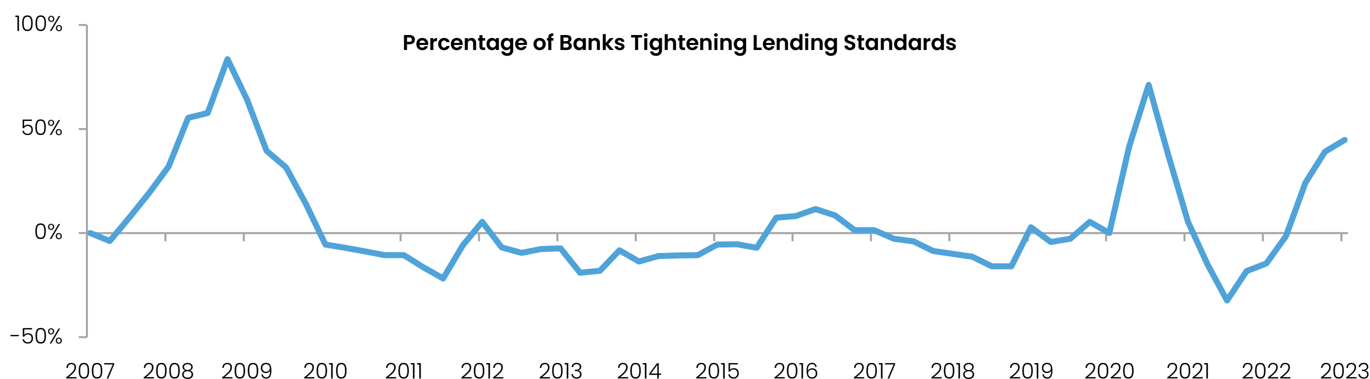
3. **Underwriting Standards:** Castlelake also believes many banks became more risk averse after the crisis, focusing on reducing their exposure to perceived risky assets or industries. Furthermore, Castlelake observed that banks began to concentrate on core markets, particularly with customers to whom they could sell multiple products and expand relationships. This refocusing following the GFC led to banks abandoning portions of the lending market that they had traditionally dominated. Additionally, for the portions of the market that banks remained committed to, they generally needed to work with larger borrowers in order to amortize the fixed costs associated with servicing these borrowers. The high fixed costs associated with banking smaller companies make servicing these borrowers less economic, leading many banks, in Castlelake's opinion, to retreat from lending to smaller borrowers.

More recently, developments across the banking sector have highlighted the mismatch in liquidity between assets and liabilities, with short-term liabilities (deposits) essentially funding long-term assets (loans). This has led to a further

[1] Office of the Comptroller of the Currency, Leveraged Lending: Guidance on Leveraged Lending, March 22, 2013
[2] Office of the Comptroller of the Currency, Shared National Credit Program: SNC Program Description and Guidelines
[3] PwC, Basel IV: BCBS Finalizes Reforms on Risk Weighted Assets, June 3, 2019
[4] Federal Reserve Bank of New York, Bank Leverage Limits and Regulatory Arbitrage: Old Question, New Evidence, December 2019

tightening of lending standards, which can be seen in Exhibit 2 below. Considering this, Castlelake believes banks may further retrench, creating an even greater opportunity set for private credit providers.

EXHIBIT 2: BANKS TIGHTENING LENDING STANDARDS



Source: FRED Net Percentage of Domestic Banks Tightening Standards for Commercial and Industrial Loans to Large and Middle-Market Firms, March 31, 2023.

Private credit growth has also been driven via the demand for yield from institutional investors, including pension funds, insurance companies and endowments. In Castlelake's opinion, these investors have had difficulty generating the returns needed to meet their liabilities from investing in the public debt markets and have thus increased their allocations to private market lending.

Investor demand for the private credit asset class has driven a dramatic increase in the size of the private credit fund universe, which appears likely to continue. According to a recent survey by Preqin, there has been an increase in the proportion of investors intending to increase their allocation to private debt, with 63% of investors looking to increase their allocation to private debt in 2022, up from 47% in 2021[1].

V. Direct Lending vs. Asset-Based Private Credit

Asset-based private credit investments typically involve two types of transactions: (i) loans against specific hard assets; and (ii) loans against diversified portfolios of credit receivable assets. Although asset-based lending tends to be common in industries with significant physical assets, such as real estate or aviation, it is also common in industries with financial assets, such as financing small and medium enterprises (SME finance), where loans can be secured by a portfolio of receivables. In asset-based private credit, the lender assesses the collateral value of the assets for the loan and typically lends a percentage of that value, with the shortfall in the capital structure being made up via equity investors. Whereas the underwriting of a direct lending opportunity is based on the lender's routine financial analysis of the company and, ultimately, the ability of the borrower to meet the loan interest payments as and when due, asset-based credit typically requires specialized expertise and extensive diligence to properly assess the value of the underlying collateral. An example of an asset-based collateral type is a diverse pool of consumer credit card receivables comprised of thousands of credit profiles and years of historical data. The lending team needs to have the specialized skills to intimately understand both the originator or sponsor of the receivables involved as well as the underlying consumer credit profile - analyzing data such as default rates, FICO scores, credit limits and many other factors. Castlelake believes underwriting such assets requires both a disciplined approach and experience in both the assets and multiple economic cycles in order for an investment to be properly valued.

Exhibit 3 below provides an illustration of Castlelake's view of some of the important differences between asset-based private credit and direct lending.

[1] Preqin Quarterly Update, Private Debt Q4 2022

EXHIBIT 3: COMPARISON OF ASSET-BASED VS DIRECT LENDING

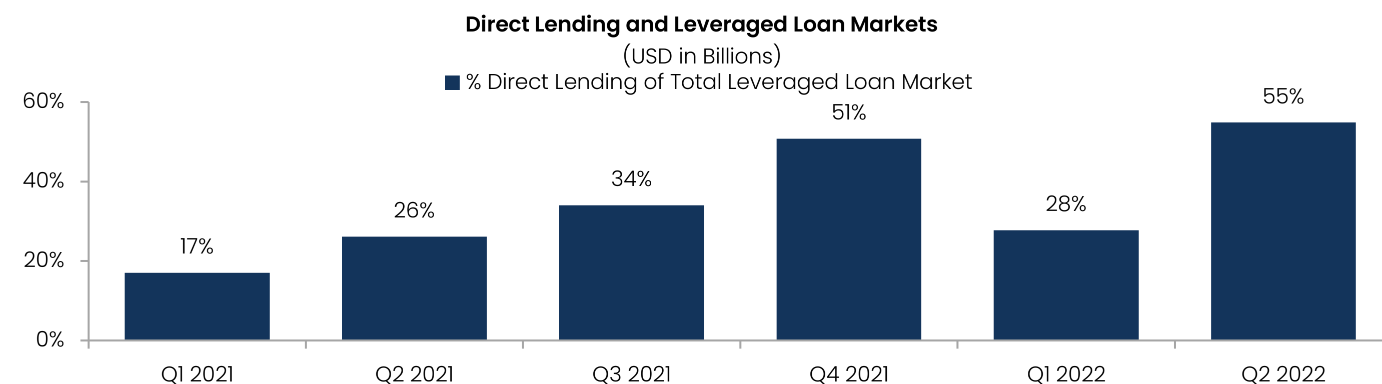
ASSET-BASED PRIVATE CREDIT		DIRECT LENDING
Cash-Flowing Assets ◄	**Collateral**	► Unsecured or Corporate Cash Flow
Limited Solution Providers ◄	**Competition**	► Dominant by Large Financial Sponsors
Dislocation in ABS Market ◄	**Catalyst for Growth**	► Dislocation in High-Yield Bond and Leveraged-Loan Market
Greater Potential ◄	**Risk-Adjusted Returns**	► Limited Potential
Specialized Asset Expertise ◄	**Underwriting**	► Standard Corporate Cashflow Underwriting
Enhanced Structural Protection/ Non-Recourse ◄	**Structural Protection**	► Limited Protection/Recourse
Fully Amortizing ◄	**Amortization**	► Bullet Maturity
Low Market Correlation ◄	**Market Correlation**	► Greater Market Correlation

VI. The Market Opportunity for Asset-Based Private Credit

While it appears that the overall market for private credit will continue to grow, we believe direct lending is overcrowded, while asset-based private credit remains underpenetrated. We believe the market for asset-based private credit is in the early stages of an expansion, just as the market for direct lending began to expand immediately following the GFC[1].

Non-investment grade corporate credit markets have shifted dramatically away from traditional bank leveraged finance markets to private direct lending markets over the last decade. This can be seen in the relative increase in direct lending deal volume and how this appears to be taking market share from the leveraged loan market as is demonstrated in Exhibit 4.

EXHIBIT 4: DIRECT LENDING WITHIN THE LEVERAGED LOAN MARKETS

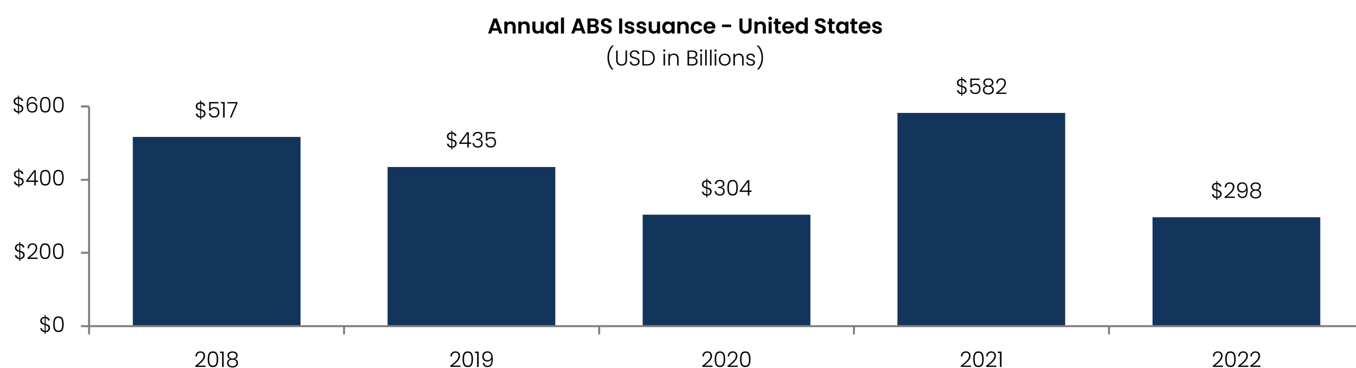


Source: Axios, Direct lending market helps keep private equity deals flowing August 15, 2022.

In Castlelake's opinion, asset-based private credit is in the early stages of a similar shift. Within the asset-based market, asset originators had traditionally not relied upon private market solutions. However, the current volatility in the securitization market is acting as a catalyst in what Castlelake believes will ultimately prove to be a secular shift toward asset originators seeking private asset-based lending solutions. Castlelake believes this will play out due to the flexibility, certainty of execution, and the support private lenders can offer to borrowers in challenging environments. Although originators will continue to rely on the securitization market to some degree, we believe asset-based private credit will become a meaningful alternative for borrowers. Exhibit 5 shows annual ABS issuance to provide context for the potential size of this market.

[1] S&P Global, Private Debt: As Lesser-Known Corner of Finance Finds the Spotlight, October 12, 2021

EXHIBIT 5: ANNUAL ABS ISSUANCE



Source: SIFMA, US Fixed Income Securities: Issuance, Trading Volume, Outstanding, November 8, 2022.

VII. The Benefits of Asset-Based Private Credit

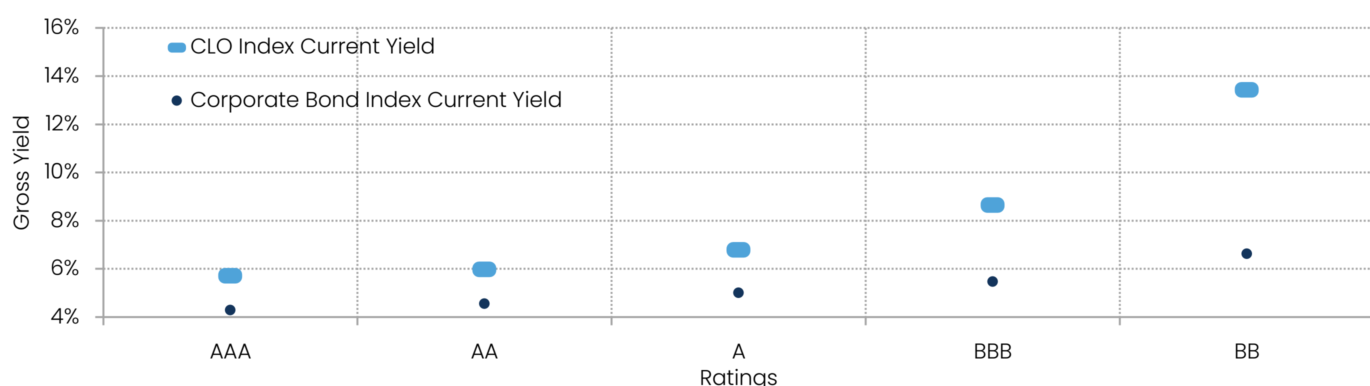
Asset-based private credit may offer investors several benefits, including attractive risk-adjusted returns, structural protection and low correlation to the broader capital markets.

Risk-Adjusted Returns

In Castlelake's view, asset-based private credit products may offer greater returns for the same ratings/credit risk relative to corporate direct lending markets. One reason is that asset-based private credit is a structured product which typically commands a greater risk-adjusted return to compensate for the specialized expertise required to underwrite and structure these investments.

An example of this concept is demonstrated in Exhibit 6 below, which compares an index of yields between several rated tranches of collateralized loan obligation (CLO) and corporate bond indices. For context, the CLO index is comprised of CLO structures that contain underlying leveraged loans, thus Castlelake believes the index is a representative proxy of structured products. The data indicates that the CLO index provides a greater yield compared to the corporate bond index for the same ratings categories. Castlelake theorizes that the same concept applies to asset-based private credit which requires greater effort and expertise to underwrite and structure and may, in turn, lead to a similar premium for lenders in these structures.

EXHIBIT 6: CLO INDEX AND CORPORATE BOND INDEX YIELDS



Source: ICE Bank of America US Corporate indices and Palmer Square CLO indices sourced from Bloomberg on April 10, 2023

Additionally, Castlelake believes the securitized market is severely dislocated, in part due to rising interest rates and economic uncertainty. In Castlelake's view, this dislocation is acting as a catalyst for asset sponsors to diversify their financing channels. Castlelake sees this dislocation as an opportunity for increased asset-based private credit activity. However, as previously discussed, asset-based lending solutions typically require specialized expertise, and the number of such solution providers is limited. Castlelake believes this imbalance of supply and demand enables asset-based private credit to continue to command relatively higher risk-adjusted returns as compared to other alternative lending strategies.

Structural Protection

Castlelake believes the risk profiles for direct lending and asset-based private credit are materially different. In our view, asset-based private credit investments typically provide a greater degree of downside protection because the liquidation of the assets that provide collateral to the lending structure creates a valuation floor. Additionally, assets that generate contractual cashflow help an investment pay down its cost basis more quickly and potentially reduce risk in the process.

We also believe structured asset-based credit products may offer a greater degree of downside protection than other private credit products through more equity subordination, amortizing structures and static capital structures (i.e. no risk of incremental debt, etc). These structures typically have several guardrails in place with the aim of providing downside protection, including covenants that govern asset eligibility criteria, concentration limits, and asset performance, with specified actions lenders can take in the event of covenant breaches.

Additionally, many of these asset-based structures typically have credit enhancements that serve to provide further downside protection. For instance, an investment may include a provision where an early amortization would be triggered if certain performance measures are not met.

Typically, in the U.S., asset-based lending is non-recourse, meaning the borrower is not liable for the repayment of the debt. Instead, the lender relies on the collateral securing the loan as a source of repayment. Given asset-based lending tends to be non-recourse, if the company that originated these assets goes into bankruptcy, the assets securing the asset-based structure would typically not be included in the bankruptcy and would instead continue to service debt payments using cashflows from the underlying assets (i.e. the portfolio is structured to be bankruptcy-remote).

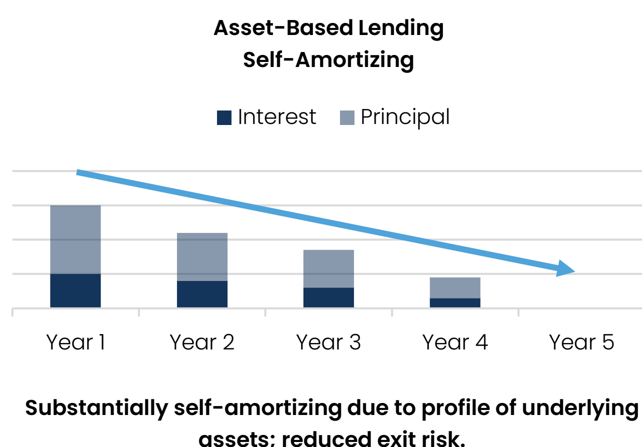
Low Correlation and Amortizing Assets

As noted earlier in this paper, asset-based private credit investments are repaid by recurring, contractual cashflows from a specific pool of collateral. Investments backed by hard and financial assets often generate front-loaded principal payments, which reduce cost basis. This self-amortizing nature of asset-based lending generally helps to shorten the duration of investments and limit broader market correlation.

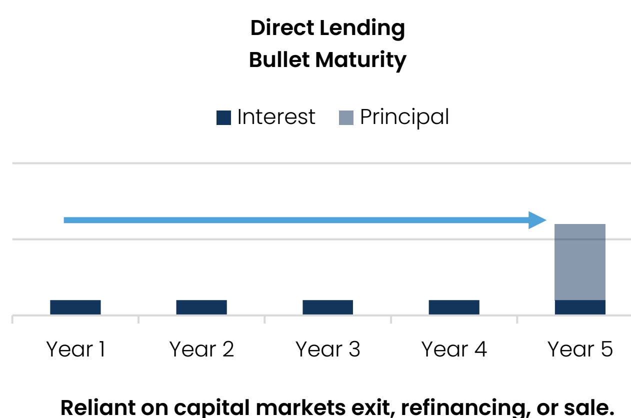
In contrast, direct lending investors typically receive interest only (or light amortization) coupons until a realization event such as a capital markets refinancing or sale of the business leads to the bullet repayment of the outstanding principal.

Exhibit 7 below demonstrates the self-liquidating nature of asset-based private credit compared to the bullet maturity structure typically associated with direct lending.

EXHIBIT 7: HYPOTHETICAL AMORTIZATION PROFILE, ASSET-BASED LENDING VS. DIRECT LENDING



Substantially self-amortizing due to profile of underlying assets; reduced exit risk.



Reliant on capital markets exit, refinancing, or sale.

Self-amortization generally reduces refinancing risk and limits broader market correlation

The self-liquidating nature of these assets may also mitigate duration risk, especially in an environment of rising interest rates. Asset-based private credit can distinguish itself due to the focus on short duration and cashflow as opposed to duration extension that one may see in corporate direct lending (which may be masking issues with current

performance).

VIII. Conclusion

In summary, Castlelake believes the market for asset-based private credit is poised to grow. Castlelake also believes asset-based private credit can offer investors attractive risk-adjusted returns while providing downside protection and low market correlation. Furthermore, Castlelake believes the differing characteristics of direct lending and asset-based lending investments can diversify overall risk in an investor's private credit portfolio, supporting the argument that allocations to both direct lending and asset-based lending can be complementary. However, each asset class has its own strengths and weaknesses, and investors should carefully consider their investment goals, risk tolerance, and other factors before deciding in which asset class to invest.

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