The Private Credit Compass

Navigating current macroeconomic conditions

MAY 2022

The Macroeconomic Outlook

As a placement agency focused exclusively on private credit, Briarcliffe sits uniquely between sophisticated institutional investors and general partners seeking capital for niche, esoteric credit strategies. At this nexus, we hear the thinking around how both are navigating current macroeconomic conditions. These include inflation, rising interest rates, repricing of equities, and delays in the global supply chain.

The diversity of private credit's substrategies makes the asset class particularly durable through all economic cycles. As one strategy contracts, another grows. Offering a deeper dive, this report examines how select strategies across Briarcliffe's Four Pillars of Private Credit offer particular resiliency to the macroeconomic conditions investors face today.

Briarcliffe's Four Pillars of Private Credit

1. Corporate Credit

- Direct Lending
- Mezzanine
- Opportunistic
- Special Situations
- Distressed
- NPL
- Secondaries
- Venture Debt

2. Specialty Finance

- Royalties
- Litigation Finance
- NAV Lending
- Insurance Linked
- Reg Cap Relief
- Consumer Lending
- Trade Finance

3. Structured Credit

- CLO
- RMBS
- ABS
- BRE

4. Real Assets Credit

- Real Estate
- Infrastructure
- Transportation
- Agricultural
- Metals & Mining
- Energy

MACROECONOMIC CONDITION 1

Inflation

The economy of the past twenty years has been defined by an abundant supply of capital, labor, and raw materials that outweighed demand, creating a sustained period of low inflation. With the onset of the Covid-19 pandemic, these conditions quickly began to reverse, setting the stage for today's highly inflationary environment. First, supply chains began to bottleneck as a collective $9.7 trillion of monetary and fiscal stimulus flooded financial and consumer markets. Then, in a further aggravation to this reversal, the Russian invasion of Ukraine sent energy and food prices soaring.

The convergence of these forces has caused an 8.5% year-over-year increase in the US Consumer Price Index, the largest increase since 1981. With more dollars circulating than at any time in history, the price of goods has nowhere to go but up.

S&P GSCI Index[1]

STRATEGY HIGHLIGHT

Real Assets | Food & Agriculture

Though many asset classes are disadvantaged by high inflation, some are particularly resilient to it, including agriculture and food production. Everyone has to eat, which, within reason, keeps food products inelastic. As marketers can pass along increased costs to the consumer, an attractive opportunity for investors exists from financing to farmers, producers, processors, and agricultural companies.

Wheat is a good example. The combined Russian and Ukrainian wheat export accounts for 28% of global supply. With planting interruptions in that region, the price of wheat contracts is now $12.79 per bushel, a 91% increase in the last 12 months. Beyond wheat, the S&P GSCI Agriculture index, which tracks broader agricultural commodity prices, rose 38% over the past year. Consumers will still eat wheat next year and as the increased costs will be passed to the consumer, credit investors will see strong returns.

Food and agriculture is an especially favorable sector when investing in vertically integrated companies. By taking ownership of various stages of production processes, rather than relying on external entities, companies can optimize production inefficiencies and reduce long-term costs. Financing to these companies will allow investors to capitalize on an increasingly consolidated industry.

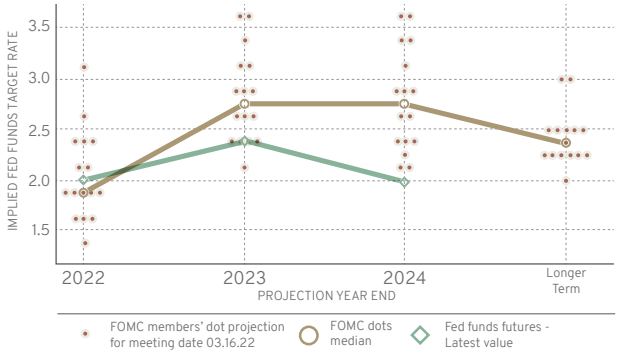
MACROECONOMIC CONDITION 2

Rising Interest Rates

One result of inflation is the inevitability of rising interest rates. For many, the current rates environment is foreign, as their experience with markets has been entirely underpinned by central bank easing. With the Federal Reserve attempting to tame inflation by increasing rates and shrinking its balance sheet at a faster pace than previously expected, 2022 will mark the strictest tightening in more than two decades. The Fed's May meeting marked the first time since 2006 that the central bank increased rates at consecutive meetings, and the first time it increased rates by fifty basis points since 2000.

Investors should expect US interest rates to continue rising likely into 2023 and potentially beyond. The Bank of England has raised rates and the European Central Bank is likely to end its nearly eight years of negative rates in the coming months. Despite these increases, private credit remains attractive as rates rise and certain strategies offer investors strong, uncorrelated returns.

The Fed's New Dot Plot[2]



Notes:
1. Source: S&P Dow Jones Indices
2. Source: Bloomberg

STRATEGY HIGHLIGHT

Corporate Credit | Special Situations & Distressed

While the floating rate nature of most private credit strategies creates increased margins to lenders in a rising rate environment, it also increases interest expense for borrowers, which can stress balance sheets and create opportunities for distressed and special situations investors. These sub-strategies have had sparse investment prospects since 2009. Immediately following the Great Financial Crisis, outstanding S&P/LSTA index leveraged loans in default hit an all-time high of 10.7%, but that rate has since averaged 2.0% annually, closing out 2021 at just under half a percent as easy money policies and accessible capital markets prevented financial distress.

These same policies also created an enormous pool of corporate debt. Today, there is $1.35 trillion of outstanding leveraged loans, representing a 127% increase from the pre-crisis high of $596 billion. However, corporate earnings are not keeping pace. Accordingly, the average leverage multiple on middle market loans has risen to 5.5x, up from 4.3x ten years ago.

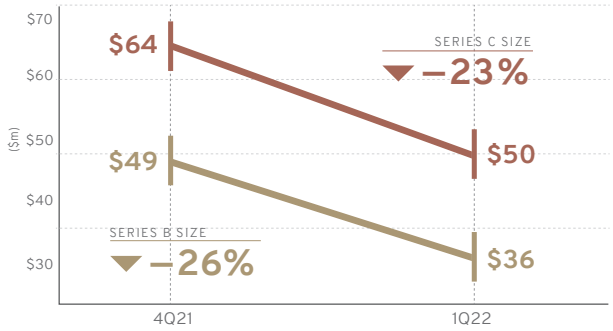
The confluence of high debt, higher leverage, and rising interest rates creates a compelling backdrop for special situations and distressed managers. These strategies can invest opportunistically when traditional credit sources are unavailable to stressed companies, and perform well by identifying durable businesses with quality assets and dependable cash flows.

MACROECONOMIC CONDITION 3

Repricing of Equity Assets

The increasing interest rate environment has not been kind to growth stocks. The Nasdaq is down 25% from its all-time high in November 2021. The ARK Innovation ETF, once the market's darling growth fund, has fallen 64% in that same period. As the Nasdaq approached its peak, the Fed sharpened its tone on rate hikes, and investors reacted by increasing the discount rate in their models. This, in turn, cut the accepted valuations of growth stocks. Suddenly, in the new reality of rapidly increasing rates, the Nasdaq was trading at a value far above what the market thought it was worth, precipitating a correction.

Decreasing Size of Growth Rounds[1]



An aggressive repricing of equity assets has resulted, including a cascade of selling in public stocks that has since flowed into private equity and venture capital as private valuations begin to reflect the public downturn. Private multiples have contracted while round sizes have decreased. The average Series C financing amount has dropped 23%, and the Series B average is down 26% between the fourth quarter of 2021 and the first quarter of 2022. The downturn in equities has given state and local government retirement funds their worst start to a year since the Covid-19 pandemic.

STRATEGY HIGHLIGHT

Corporate Credit | Growth & Venture Debt

Early-stage credit strategies can benefit from equity downturns as the pipeline for venture and growth deals transitions from equity to debt. During periods of multiples compression, companies face a predicament of a down-round to raise capital as their runway diminishes. In this scenario, growth debt offers an alternative, non-dilutive capital solution that can be utilized to avoid the potential down-round. Companies with proven market traction, especially in technology and healthcare, can use structured credit to provide liquidity when equity capital markets are unfavorable. During these times, lenders have negotiating power over terms and pricing, and can structure loans to provide optimum income and downside protection.

Hitting $330 billion, venture equity investing has doubled between 2021 and 2022, posting its best returns since the dot-com bubble. Venture capital investments propelled many university endowments to 50%+ net returns. The average valuation of an early-stage US startup shot up more than 50% to $96 million between the first half of 2020 and first half 2021. Given those exceptional returns, slowing equity deal flow, and the cautionary shift in market sentiment, growth debt is likely to garner more attention from investors as their need for downside protection increases with the shift in market dynamics.

Notes:
1. Source: TechCrunch

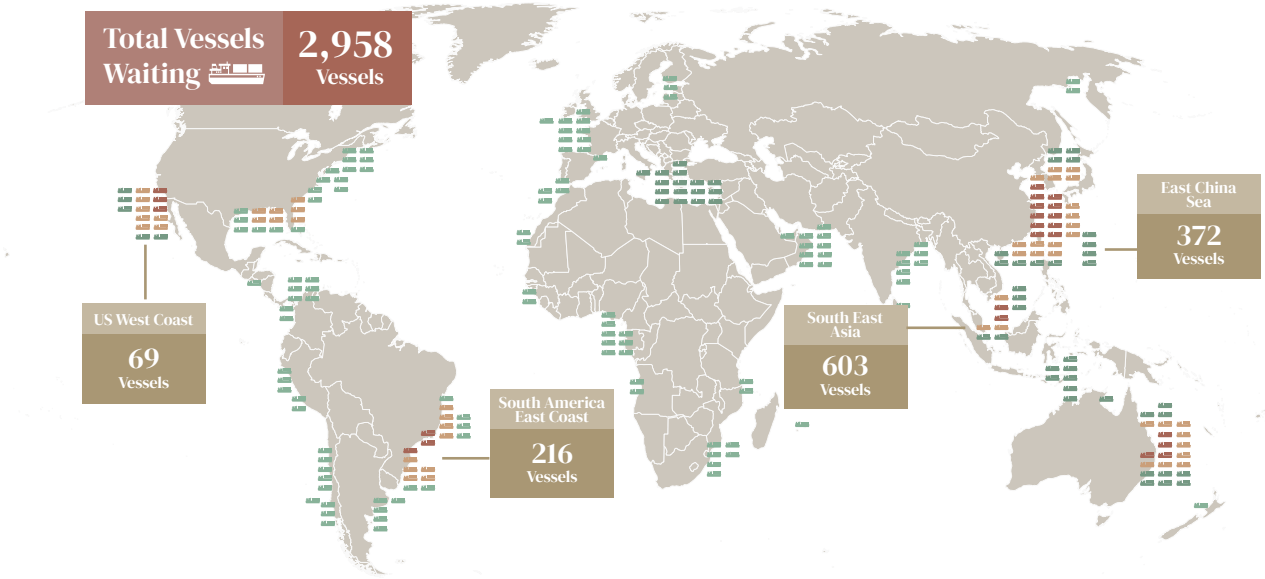
MACROECONOMIC CONDITION 4

Supply Chain Delays

The Covid-19 pandemic was disastrous for supply chains, and the problems it caused are yet to be fully corrected. While much of the world's population was in quarantine in 2020, consumers ordered goods en masse, and governments scrambled to procure vital goods from across the world, creating unprecedented demand. Concurrently, factories and ports remained closed or impaired, creating an equally unprecedented non-existence of supply. Even as factories came back online, new protocols and safety standards kept the movement of goods at a crawl, doubling the transpacific shipping time from the year before.

These conditions persist and have been further aggravated by Russia's invasion of Ukraine and China's recent lockdowns. More than one million containers in China that were scheduled to arrive in Europe via Russian railways must now find new routes by sea. This demand is further clogging maritime routes at the same time China's so called "Zero-Covid" approach has once again taken large ports out of service.

Global Port Congestion[1]



STRATEGY HIGHLIGHT

Real Assets | Shipping

The global shipping industry has been a beneficiary of supply chain complications and the shortage of space on ocean vessels. Transpacific shipping costs are 12 times higher than they were two years ago. However, input costs rose only a fraction of that, bolstering the industry's top and bottom lines. As ships reach the end of useful life, they are scrapped for steel. Since 2020, the value of steel has increased 43%, which is providing additional revenue for ship owners.

In addition to the dramatic increase in shipping costs, to secure space, the average container ship lease duration has exploded to 800 days, a 700% increase from before the Covid-19 pandemic. The combination of demand for space, increased cash flow from longer leases, and the rising value of steel has been a tremendous windfall for the shipping industry.

Notes:
1. Source: VesselsValue

A Hearty and Growing Appetite

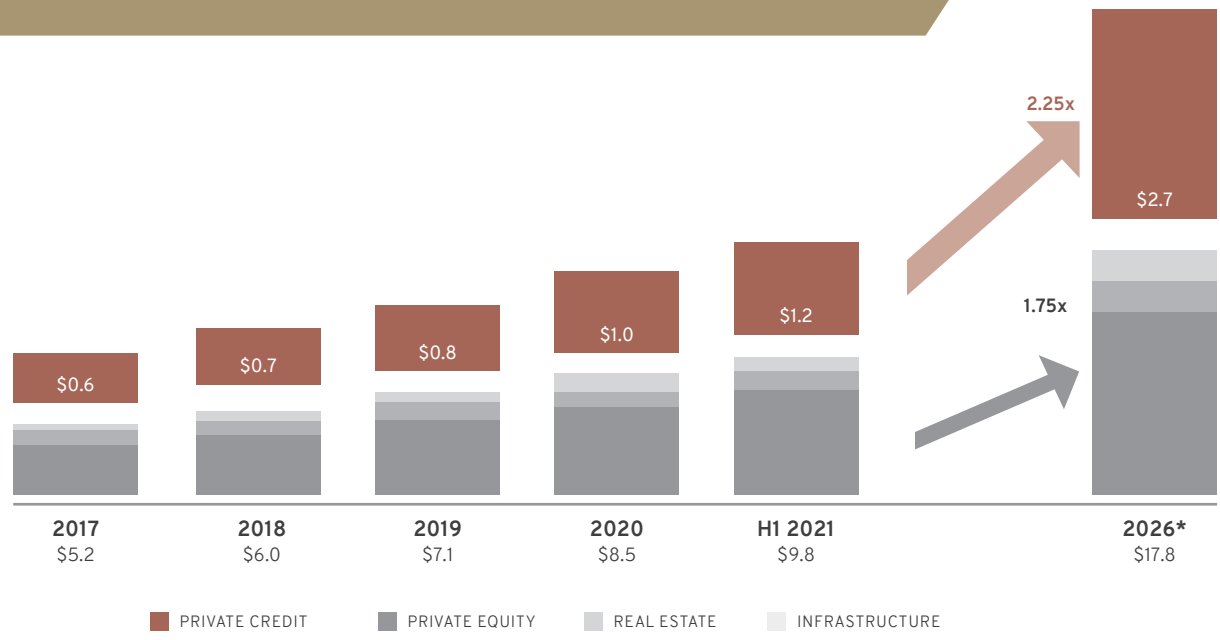
Macroeconomic issues impact all private asset classes, but investors value private credit, especially during volatile times, in part because of its resilience to market risks. Forecasts indicate that private credit allocation will increase at a greater rate than that of other alternatives, with expectations to exceed $2.7 trillion in the next few years, outpacing private equity growth by nearly 30%. As private equity saturates and matures, return hurdles are becoming increasingly difficult to meet, and investors are reshaping their private allocations to include more credit. Similarly, even with interest rates rising, fixed income does not offer the return or yield investors require, so they are shifting more of that allocation to private credit strategies, as well.

Where We Sit Today

Due to the contractual nature of private credit, investors will continue to earn income, even in volatile markets or market downturns, providing an additional "smoothing" effect to their portfolios through those cycles. To protect against unpredictable market trends, investors should seek uncorrelated strategies and specialist managers.

Despite macroeconomic headwinds for the broader market, private credit offers opportunities to mitigate against and capitalize on these conditions. These are precisely the strategies Briarcliffe represents. ■

Private credit AUM is growing faster than other private market asset classes[1] ($ trillion)



Notes:
1. Source: Preqin

BRIARCLIFFE CREDIT PARTNERS

Exclusively private credit

As private markets have grown beyond $10 trillion and become more competitive than ever, Briarcliffe Credit Partners is the first, and only, exclusively dedicated private credit placement agency. Led by a team of 13 professionals with deep expertise and passion for this growing asset class, our differentiated and methodical approach has a demonstrated track record of raising sophisticated institutional investor capital for leading private credit strategies globally.

Specialized focus

Our proven mid-teens return strategy encompasses investments of these types:

- Fund II or higher
- Top Quartile Performance
- Fund Size $500m – $2bn
- Net IRR: >10%

Uniquely selective

We act very selectively to provide positive offerings for investors. Of the 50+ GPs we meet with each quarter, only one or two mandates are selected.

Our team

FIRM

Jess Larsen
Founder & CEO

Robert Molina
Head of Origination

Laura Morales
Head of HR & Office Infrastructure

Ryan Tirre
Head of Marketing

GP ADVISORY

Kyle Abel
Head of GP Advisory

Conner Brophy
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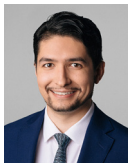

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