Private Credit Fundamentals and Market Structure

Interview preparation summary · PC track

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INT.CF.1.a · The market

Place a loan on the private credit map by strategy and seniority, and explain the risk, return and leverage attachment points of each.

Private credit is lending by non-bank funds outside the public bond and broadly syndicated loan markets. The main strategies form a risk ladder. Senior direct lending is first-lien, floating-rate lending to mid-sized, usually sponsor-owned companies, often at four to six times EBITDA with a spread of several hundred basis points over a base rate. Unitranche combines first-lien and second-lien risk in one loan from one lender or a small club at a single blended price. Second lien and mezzanine sit behind it, pay more, often include PIK interest or warrants, and absorb losses first. Asset-backed lending is sized on the value of receivables, equipment, property or loan pools rather than on a cash flow multiple. Special situations lending finances stressed or complex borrowers for higher returns and more control. Test any loan with two numbers: where it attaches and detaches as a multiple of EBITDA, and the loan to value at detachment. The usual mistake is quoting a yield without saying how much value sits beneath the lender.

WORKED EXAMPLE: READING THE CAPITAL STRUCTURE OF A LAB-TESTING BUSINESS

Corvane Testing has EBITDA of 20m and is bought at an enterprise value of 180m, which is 9.0x. The financing is a first lien of 80m at a spread of 500 basis points, a second lien of 30m at 950 basis points and mezzanine of 20m. Where does each tranche attach and detach, and how much can value fall before each is impaired? Convention: ignore costs and fees, and treat enterprise value as the amount available to creditors.

Answer: The first lien attaches at 0x and detaches at 4.0x (44.4% loan to value), the second lien detaches at 5.5x (61.1%) and the mezzanine at 6.5x (72.2%). The mezzanine is hit by a 28% fall in value, the second lien by 39% and the first lien only by 56%.

> **Interview tip:** Say where the loan sits in turns of EBITDA and as a percentage of value before you mention yield. Then say how far value can fall before you lose money.

INT.CF.1.b · The market

Compare sponsor and non-sponsor lending, and explain how risk, pricing and protections differ between them.

A sponsor loan finances a company owned by a private equity firm. The sponsor brings an equity cushion, professional governance, regular reporting, a reputation with lenders and, often, the willingness to inject more equity to cure a covenant breach, though never a legal duty to do so. Competition for these loans is intense, so margins are lower, leverage higher and documents more borrower friendly. A non-sponsor loan goes to a family or founder-owned business, a listed company or a corporate carve-out. There is no repeat player to lean on, so the lender relies on its own diligence, lower leverage, tighter covenants, monthly information, security and personal alignment from owners, and charges a higher margin and larger fees. Compare the two on yield to a likely takeout, loan to value, interest cover after a stress and the quality of support. The usual mistake is to treat sponsor support as a guarantee, or to read higher non-sponsor spread as free return rather than payment for work and risk.

WORKED EXAMPLE: PRICING A SPONSOR LOAN AGAINST A FOUNDER-OWNED LOAN

Both borrowers have EBITDA of 15m and the base rate is 4.0%. Sponsor-owned Harbrook Plastics is bought at 10.0x EBITDA (150m) with a 75m first-lien loan at base plus 5.50%, issued at a 2.0 point discount. Founder-owned Teller Fasteners is valued at 7.5x EBITDA (112.5m) with a 52.5m loan at base plus 6.50%, issued at a 3.0 point discount. Compare the two for a lender. Convention: a three-year takeout, discount spread evenly over three years, cash interest only.

Answer: The founder loan earns about 133 basis points more (7.50% against 6.17%) and has more cover (2.72x against 2.11x, and 1.90x against 1.47x after a 30% EBITDA fall). The sponsor loan is cheaper and more leveraged, so its protection is the sponsor's equity and conduct, not the numbers alone.

> **Interview tip:** Say that the extra spread on a non-sponsor loan pays for diligence, monitoring and the missing sponsor, and then show you can price it as yield to takeout rather than headline margin.

INT.CF.1.c · The market

Explain why borrowers choose private credit instead of banks or the broadly syndicated loan market, and what it costs them.

Borrowers choose private credit for certainty, speed and flexibility. A direct lender or small club commits the whole amount, so there is no syndication risk and no market flex, a change to pricing or terms after launch when investors are cautious. Execution often takes weeks rather than months, the lender can underwrite a business with no rating or with adjusted EBITDA that public investors would resist, and a delayed-draw tranche can pre-fund acquisitions. With few lenders, amendments and waivers are negotiated by phone rather than through a vote of many holders. Banks have pulled back from leveraged mid-market lending because of capital rules, and the broadly syndicated market suits larger, rated, liquid credits. The cost is a higher margin and fees, call protection that makes early repayment dearer, and tighter information and covenant packages. Measure the price as all-in yield over the expected life and as the marginal cost of any extra leverage obtained. The usual mistake is to say private credit is simply more expensive without saying what is bought.

WORKED EXAMPLE: WHAT DOES A SPONSOR PAY FOR CERTAINTY?

Larkmoor Components has EBITDA of 24m and the base rate is 4.0%. A syndicated loan would be 5.0x (120m) at base plus 4.00% with a 1.0 point discount. A direct lender offers 5.5x (132m) at base plus 5.75% with a 2.0 point discount, and commits the full amount before signing. Compare the cost. Convention: both loans are repaid after four years, discount spread evenly, cash interest on the full balance.

Answer: Direct lending costs 200 basis points more over the base rate, about 2.4m a year on 120m, and the extra 12m of leverage costs about 30% at the margin. A sponsor accepts it when certainty of closing, speed and flexibility are worth more than the price.

> **Interview tip:** Name the benefits first (certainty, speed, flexibility), then quantify the cost. Interviewers like a candidate who shows that more leverage at a higher price is not the same as cheaper money.

INT.CF.2.a · The funds

Describe private credit fund and BDC structures and vehicle types, and explain deployment, recycling and fund life.

Most private credit is held in a closed-end drawdown fund. Investors commit capital, the manager calls it as loans are made, and the fund returns cash as loans are repaid over a fixed life of perhaps seven to nine years, with an investment period of two to four years in which repayments can often be recycled. A business development company (BDC) is a US-style regulated vehicle that lends to mid-sized companies and typically distributes most of its income; it may be listed, with a share price that can differ from net asset value, or unlisted with limited redemptions. Evergreen or open-ended vehicles have no end date and allow periodic subscriptions and redemptions, usually with gates. Separately managed accounts serve one large investor on bespoke terms. Deployment matters because undrawn commitments earn nothing, so income as a share of commitments is low while the fund ramps up and fees can drag returns. The usual mistake is to compare yields on invested capital without allowing for the ramp.

WORKED EXAMPLE: THE COST OF A SLOW RAMP-UP

Wexham Direct Lending Fund has 600m of commitments. Its loans earn 10.0% on invested capital. Invested capital is 40% of commitments at the end of year 1, 80% at the end of year 2 and 100% at the end of year 3, rising evenly within each year. The manager charges 1.0% a year on commitments (6m). What do investors earn in each year? Convention: ignore losses, leverage and repayments.

Answer: Income on commitments is 2.0%, 6.0% and 9.0% against a 10.0% loan yield, and with a commitment-based fee investors earn 5.0%, 8.3% and 8.9% on the capital actually invested.

Interview tip: Show that you know yield on invested capital and return on commitments are different numbers, and say which one the investor actually experiences during the ramp.

INT.CF.2.b · The funds

Calculate how a private credit manager earns through management and incentive fees, and the net return to investors after a hurdle and catch-up.

A credit manager earns a management fee, often one to one and a half per cent a year, charged on invested capital or on commitments, and an incentive fee, typically ten to fifteen per cent of profits. Because a credit fund's gross return is largely contractual interest, the incentive fee is usually paid only above a hurdle, also called the preferred return, of perhaps five to seven per cent a year. A catch-up then lets the manager receive most or all of the profit above the hurdle until it holds its full share of total profit; with full catch-up and enough return, the incentive equals its percentage of all profit. Calculate in order: gross profit, less management fee, then the hurdle amount, the catch-up and the split of the rest. Investors then judge net return, not gross. Watch the fee base, whether fees step down after the investment period, whether loan fees are shared with investors, and clawbacks. The usual mistake is to apply the incentive percentage to profit above the hurdle only, ignoring the catch-up.

WORKED EXAMPLE: NET RETURN FOR AN INVESTOR IN ALDWICK SENIOR FUND

Aldwick Senior Fund has 400m invested. The portfolio earns a gross profit of 40m (10.0%) after fund costs. The manager charges 1.25% a year on invested capital, an incentive fee of 12.5% of profit, a 6% hurdle and a full catch-up. What is the investor's net return? Then repeat with a gross profit of 32m. Convention: one year, hurdle tested on profit after management fee.

Answer: The investor nets 7.66% from a 10.0% gross return, because the manager takes 5.0m of management fee and 4.375m of incentive fee. If gross profit is only 32m, the catch-up absorbs the whole excess and the investor gets exactly the 6.00% hurdle.

Interview tip: Walk through the order: fee, hurdle, catch-up, split. Say the net figure at the end and name the zone where the catch-up leaves the investor on the hurdle.

INT.CF.2.c · The funds

Explain fund-level leverage, subscription lines and NAV facilities, and calculate their effect on equity returns and risk.

Credit funds borrow at three levels. A subscription line is a short-term facility secured on investors' undrawn commitments; it lets the manager fund loans before calling capital, which lifts IRR by shortening the time capital is outstanding but not the money multiple. Asset-level or fund-level credit facilities lend against a pool of loans at an advance rate, and a BDC or fund may run roughly half a turn to a turn or more of debt to equity. A NAV facility lends against the value of a portfolio, often to a fund that holds investments and wants to pay distributions or fund follow-ons, at a loan to value well below the assets' marks. Leverage raises equity return only while the net return on assets exceeds the cost of debt, so credit losses reduce the benefit, and it magnifies falls in value: equity loses debt-to-equity-plus-one times the percentage fall. Test covenants such as asset coverage. The usual mistake is to quote levered returns without a loss stress.

WORKED EXAMPLE: LEVERING A SENIOR LOAN FUND

Ridgeway Senior Fund has equity of 300m and borrows 300m (debt to equity of 1.0x), buying 600m of loans that yield 10.5% a year. The debt costs 6.5%, which is the 4.0% base rate plus 2.5%. Compute the equity return with no losses, then with annual credit losses of 3.0% of assets, find the loss rate at which leverage stops helping, and stress a 20% fall in asset value. Convention: before management fees, one year.

Answer: Leverage lifts the equity return from 10.5% to 14.5% with no losses and from 7.5% to 8.5% with 3.0% losses. It stops helping at a loss rate of 4.0% a year, and a 20% fall in asset value costs equity 40%.

> **Interview tip:** Say that leverage is a spread business: it helps while assets earn more than the debt costs after losses, and it doubles the damage when value falls.

Summary of the Charta interview-preparation topic. Companies and figures in the examples are invented. Draft content, not yet expert reviewed.