Private Credit

Comillas Private Equity & Venture Capital Club

Private Markets 101

Map of the Course

- Understanding Private Markets
- Private Equity
- Venture Capital
- **Private Credit**
- Infrastructure and Real Estate Investments

What is Private Credit?

Non-bank, non-public lending

Customized and illiquid loans targeted at private companies, often in the middle-markets

Boomed post-2008 as private lenders stepped in to fill the gap left by traditional banks

Bonds vs Loans – Fixed vs Floating

Bonds	Loans
Public / Semi-public	Private
Standardized	Tailored
Liquid (tradable)	Illiquid
Covenant-lite	Tight covenants[1]
Institutional holders	Private debt funds

	Fixed Rate	Floating Rate
Interest	Constant	Variable (SOFR[2])
Inflation hedge	Weak	Strong
Common in...	Bonds	Private Credit
Who bears rate risk?	Lender	Borrower
Example	6%	SOFR + 6%

1. Covenants. are lender protections in loan contracts such as limits on debt or required ratios.
2. Secured Overnight Financing Rate (SOFR) is a benchmark rate used to set loan interest that adjusts daily based on U.S. Treasury rates.

Capital Stack and Credit Ratings

Capital Stack

SENIOR DEBT

1. SECURED SENIOR DEBT
2. SECOND LIEN DEBT
3. UNSECURED SENIOR DEBT

MEZZANINE

4. SUBORDINATED DEBT
5. PREFERRED EQUITY

6. COMMON EQUITY

LOWER RISK
LOWER RETURN

HIGHER RISK
HIGHER RETURN

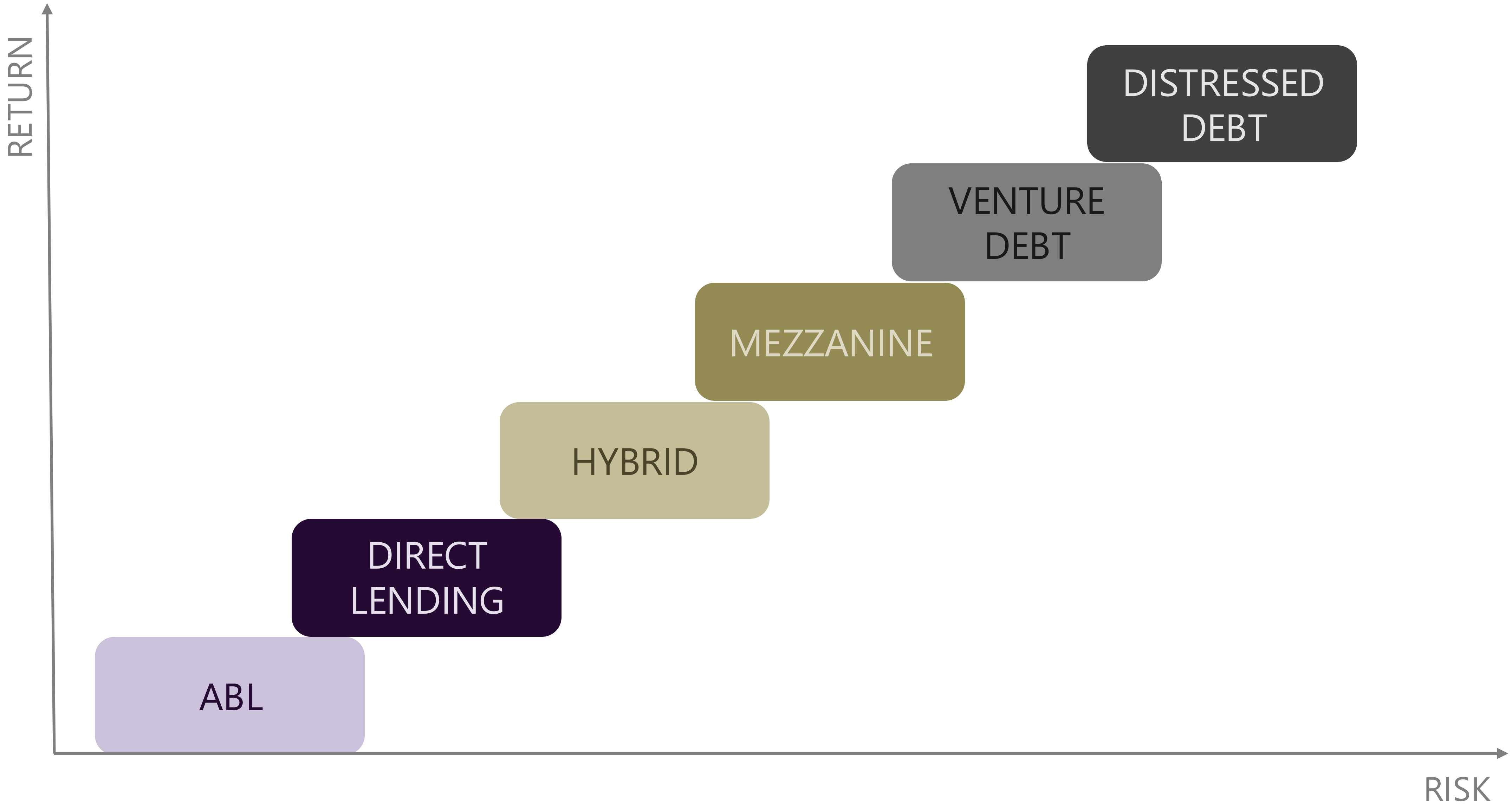
Credit Ratings[1]

Rating	
AAA	High-grade loans, bonds
AA	
A	
BBB	
BB	Subordinated Debt, high risk loans
B	
CCC	Deeply distressed, likely default
CC	
C	

1. Credit Ratings are issued by agencies like **S&P** and **Moody's**, and are standardized assessments of a borrower's creditworthiness. They help investors evaluate **default risk** and price debt appropriately in order to compare credits across markets.

Private Credit Strategies

Main Private Credit Strategies



Asset-Backed Lending (ABL) & Direct Lending

ASSET-BASED LENDING (ABL)

Backed by tangible collateral[1].
Typical in capital-intensive sectors.

- Collateral includes inventory, receivables, equipment…
- Capital-intensive sectors include industrial, transportation and construction among others.
- Return: **~5-8%**

Direct Lending

It refers to loans made directly by private credit funds to private companies

- Often used in LBOs.
- Typically senior secured, but can also be subordinated debt (higher risk)
- Return: **~7-10%**

Senior Debt

- Highest priority
- Loans are collateralized[1]
- Lower risk and lower return

Subordinated Debt

- Lower priority
- Typically uncollateralized
- Higher risk and return

1. Collateralized: backed by specific assets that the lender can claim if the borrower defaults (e.g.: mortgage).

Hybrid & Mezzanine Debt

"Hybrid"

Flexible instruments that blend features of debt and equity.

- Unitranche Loans: senior + subordinated in one tranche[1].
- PIK[2] Notes: interest paid in more debt instead of cash.
- Preferred Equity: equity-like instruments with fixed returns and priority over common equity.

Return: **~9-12%**

Mezzanine Debt

Subordinated debt with higher risk, often used to fill financing gaps.

- ✓ It assists GPs in the completion of PE buyouts.
- ✓ Lender may participate in equity through warrants[3].
- ✓ Interest payments may be deferred until the maturity.

SENIOR DEBT

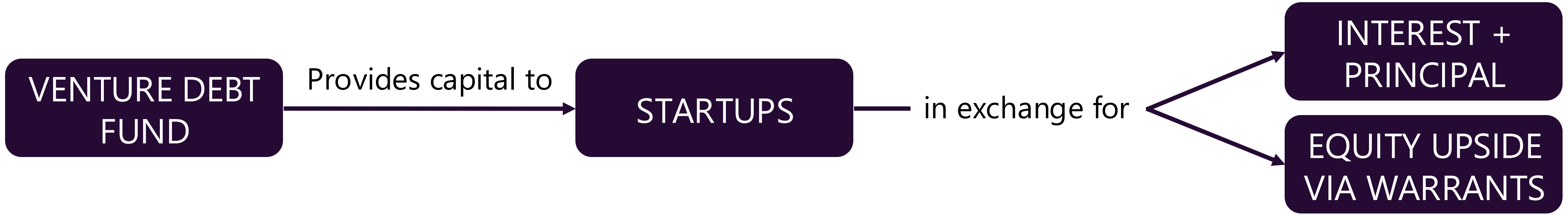
MEZZANINE

EQUITY

1. Tranches are portions of a loan with distinct risk, return and seniority characteristics.
2. Payment-In-Kind is a loan feature that increases leverage over time through interest.
3. Warrants give the lender the right to exchange its debt for equity in the company, allowing them to benefit from potential upside

Venture Debt

Since traditional banks avoid financing startups, venture debt funds step in to provide capital to these high-growth, VC-backed companies.



	Venture Capital	Venture Debt
Capital Structure	100% Equity	Debt + Equity Warrants
Dilution[1]	High dilution	Lower dilution
Return Profile	All equity upside – exit-driven	Fixed income + optional upside
Cash Flow Impact	No repayments	Regular repayments

1. Dilution refers to the reduction in ownership percentage caused when new equity is issued

Venture Debt vs Venture Capital – Example

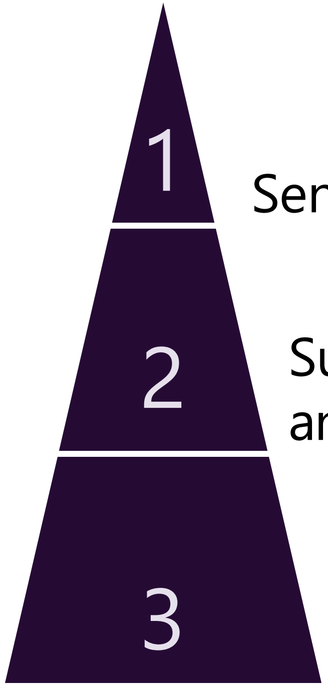
A group of investors invests $2M in venture debt but receives only 25% of that amount in equity, which represents 4.17% of the startup. Another group invests $2M in equity and receives 16.67% of the company. After 10 years, the company's valuation has increased 10x and it has repaid the $1.5M loan plus interest. While the Venture Capital is more **profitable**, Venture Debt option gives the first group of investors **priority** in the event of **bankruptcy** – and provides **higher liquidity**.

	VENTURE DEBT	VENTURE CAPITAL
Round Amount	$2,000,000	$2,000,000
Dilution Percentage	25%	100%
Amount Invested	$500,000	$2,000,000
Company Valuation	$10,000,000	$10,000,000
New investor's equity stake	4.17%	16.67%
Value appreciation	X10	X10
Exit value	**$5,000,000**	**$20,000,000**
Capital & Interest Repayment	**$1,650,000**	**$0**
TOTAL RETURN	**$6,650,000**	**$20,000,000**

Distressed Lending

Focused on investing in debt that is stressed or already in default and that is purchased below par value. It is focused on price appreciation rather than yield as the loan may not be paying principal and interest as scheduled

PRIORITY OF CLAIMS IN BANKRUPTCY



1. Senior & Collateralized Debt
2. Subordinated, Uncollateralized and Mezzanine Debt
3. Equity

- Buys distressed debt at **deep discount**.
- The goal is not yield – it is **control** or **recovery**.
- Also provides **DIP financing**[1] in bankruptcies.
- High legal focus.
- Return: **~13-20%**

EXAMPLE

Fund buys bonds at 30¢ on the dollar, then negotiates a restructuring and ends up owning 40% of the reorganized company.

1. Debtor-in-Possession (DIP) Financing is a special type of loan given to companies under bankruptcy protection, allowing them to keep operating during restructuring.

Private Credit Fund Mechanics

Fund Structure Basis

Typically structured as closed-end vehicles similar to Private Equity funds – managed by a GP and backed by LPs. They also operate under a management fee (1.5%) and an incentive fee (15%).

General Partner	Limited Partners
Fund manager – underwrites loans.	Institutional investors – commit capital and receive returns.

TYPES OF PRIVATE CREDIT FUNDS

BY INVESTMENT STRATEGY

- Direct Lending Funds
- Asset-Backed Funds
- Mezzanine Funds
- Venture Debt Funds
- Distressed Debt Funds

BY FUND STRUCTURE

- BDCs
- Evergreen / Semi-liquid Funds

BDCs – Business Development Companies

1

U.S. based, can be publicly traded or non-traded BDC. They provide debt to small and mid-sized private companies.

2

Distribute ≥90% of income. Cash flows are not taxed at the BDC level.

3

They are considered the REITs[1] of private credit – income-focused, liquid but still tied to private market assets.

1. A Real Estate Investment Trust (REIT) is a company that owns or finances income-producing real estate assets and must distribute most of its earnings to shareholders.

Evergreen Funds – Open-end Funds

No termination date. Investors can enter or exit periodically.

NAV[1] is updated regularly.

They are not daily liquid – access is limited but they typically offer quarterly redemption[2] windows.

Investors can request redemptions every quarter but:

- There is usually a cap (e.g. 5% of NAV per quarter).
- Redemption requests may be prorated[3] if demand exceeds the cap.
- Fund manager may suspend or defer redemptions in times of market stress.

1. Net Asset Value (NAV) is the total value of a fund's assets minus liabilities, usually expressed per share – it represents the fair value of the investment portfolio.
2. A redemption is the process by which an investor withdraws money from the fund, typically by selling their shares back to the fund.
3. Each investor receives a proportional share of the total amount allowed for withdrawal as GPs cannot sell quickly without impacting value.

Due Diligence Process in Private Credit – Underwriting

UNDERWRITING

Underwriting is the process by which a lender evaluates the risk, structure and terms of a private loan before committing capital.

KEY GOALS

- ✓ Ensure the borrower can repay the loan.
- ✓ Define the appropriate structure.
- ✓ Protect the fund from downside risk

1. BORROWER FINANCIALS

   EBITDA, leverage, FCF[1] profile…

2. BUSINESS & INDUSTRY ANALYSIS

   Sector cyclicality, competitive position.

3. SPONSOR REVIEW

   If PE-backed, track record is reviewed.

4. COLLATERAL & COVENANTS

   Asset coverage, covenant protections.

5. LEGAL DOCUMENTATION

   Loan agreement terms.

1. Free Cash Flow (FCF) is the cash a company generates after covering operating expenses and capital expenditures. It is used to repay debt, reinvest or distribute.

Key Terms Recap

Term	Definition
Covenant	Contractual rule in a loan to protect the lender (e.g. leverage limits).
Collateral	Assets pledged by the borrower as security for the loan. Lender can claim collateral if borrower defaults.
Warrants	Right to buy equity at a fixed price, giving lenders upside potential.
SOFR	Secured Overnight Financing Rate – a benchmark for floating interest rates.
Floating Rate	Interest that varies with a benchmark (SOFR or EURIBOR).
ABL	Asset-Backed Lending – loans secured by assets like receivables or inventory.
PIK Notes	Payment-In-Kind – loans that pay interest in more debt instead of cash.
DIP Financing	Debtor-In-Possession – loans to companies in bankruptcy to help them keep operating during restructuring.
BDC	Business Development Company – U.S. fund structure that lends to private companies often public or semi-liquid.
NAV	Net Asset Value – total fund assets minus liabilities, per share.
Redemption	When an investor withdraws money from a fund.
Prorated	When redemptions exceed limits, each investor gets a proportional amount.
Underwriting	Risk evaluation and structuring process before approving a loan.