TD Global Investment Solutions

Investor Knowledge 10 Minutes

Why are investors enamored with private credit?

An explanation on how this growing industry works

Sub-investment grade private credit ("private credit") has seen tremendous growth in the past decade. Private credit offers the key benefits of higher cash yield, higher total return and lower volatility compared to broadly similar public fixed income securities.

Industry wisdom tells us that these come in exchange for a lack of liquidity, lack of public credit rating, as well as opaque security valuation in the asset class. Despite less transparency, private credit investors benefit from covenants and collateral packages that improve the overall credit experience, including lower default rates and higher recovery rates in times of stress. In exchange for such benefits, investors accept a high degree of Illiquidity and long hold periods - making the asset class suitable for more sophisticated investors willing to understand and accept these tradeoffs.

Private credit portfolios are actively managed and rely heavily on specific manager skillsets: **(i) proprietary origination channels, (ii) specialized teams to conduct due diligence and monitoring,** as well as **(iii) additional execution and administration duties and costs compared to public fixed income portfolios.** Thus, each manager's portfolio exposures will look different not only from public bond portfolios but also from the peers and competing managers.

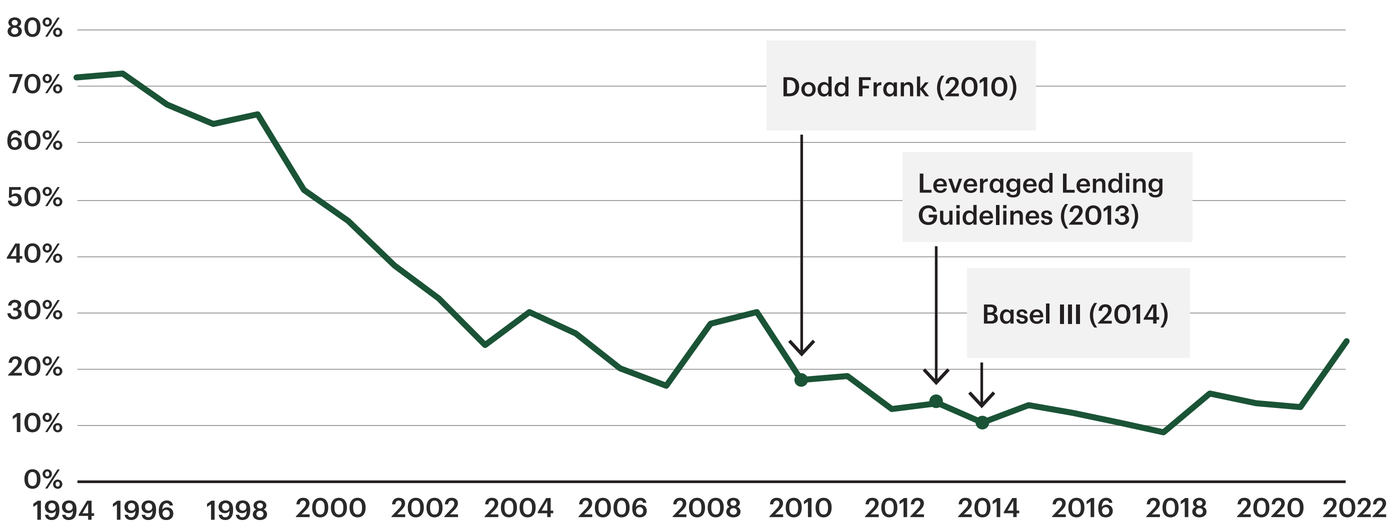
Lately in the post-COVID era, private credit gained prominence due to its strong performance – particularly in an environment of rising rates. This paper addresses historical context, describes transaction and security types, illustrates recent market trends, and provides a forward-looking view of how the asset class might develop going forward. These aspects will hopefully provide analytical context on why and how institutional clients may consider private credit strategies in their portfolio construction process.

Historical Context

Prior to the Global Financial Crisis of 2008-09, private credit was a strong but constrained market, serviced by some Commercial banks and many Wall Street banks – specifically their syndicated lending, leveraged lending and sponsor lending groups. After the passage of the Dodd-Frank Act of 2010, risky lending at banks was heavily curtailed, providing opportunities for non-bank lenders to fill the void. The market for private lending has evolved considerably in the last 15 years.

Forms of private syndicated and direct lending grew rapidly in this vacuum. Private non-bank lenders provide loans to small and middle-market companies, often backed by private equity firms, secured either by an array of different hard assets or a general pledge of cash flow streams.[1] So-called 'Direct Loans' are originated and held by the lender and not broadly syndicated. Direct Loans contrast with the 'Broadly Syndicated Loan' market,[2] the domain of larger borrowers who have the greater size, financial infrastructure and a lender following that permits more standardized terms and tighter spreads in return for an expectation of greater transparency, loan liquidity and more modest risk. As is shown in **Figure 1**, banks' market share in the Leveraged Loan Market has steadily fallen over time as other forms of private capital increasingly filled the void created by regulatory changes.

Figure 1: Banks' Share of Leveraged Loan Market



Source: PitchBook. As at June 30, 2024.

As Wall Street and Commercial banks have retreated, a host of non-bank lenders have increasingly dominated the private credit space. Those institutions are mainly credit managers but can provide private lending capital from a host of different investment vehicles– including private equity style pooled 'vintage' funds, segregated accounts, open-ended 'evergreen' fund structures, Business Development Corporations ("BDC"s) and even ETFs.

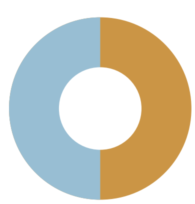
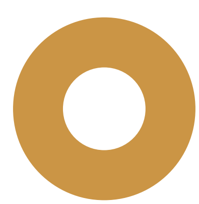
[1] Credit exposure to corporate entities entail repayment from corporate operational cash flows, while asset loans entail repayment from the cash generated by a single asset or portfolio of asset(s).

[2] Definitions are not iron-clad in private credit, but this market is also referred to as the "Leveraged Lending" market.

Typical Lending Structures

Understanding the lending market means understanding how banks and non-bank lenders intersect in the provision of capital to a host of corporate or other institutions in the marketplace. The provision of capital solutions was traditionally dominated by banks, be it Commercial Bank lending ("IG" loans) or syndicated/leveraged lending done out of bank-owned investment dealers. **Figure 2** outlines some of the main structures for sub-IG lending.

Figure 2: Typical Lending Structures Execution

	Non-Investment Grade		Investment Grade
Form of Execution	Best Efforts – No Market Risk Fully Underwritten – Distribution / Market Risk		
Products Offerings	**Bank Revolvers** **Bank Term Loans** **Institutional Term Loans (1st/2nd Lien)*** **High Yield Bonds*** **TDAM access to transactions**		**Bank Revolvers** **Bank Term Loans** **Capital Markets Bridges**
Target Borrowers	**Financial Sponsors**  **Corporates**		 **Corporates**
Long-Term Capital Requirements	**Small** Traditional Bank Revolvers/ Term Loans where holds can be higher	**Larger** Bank Revolvers Bank Term Loans	**Large** Bank Revolvers Bank Term Loans

Source: TD Asset Management Inc. As at June 30, 2025.

*Includes mezzanine and bespoke financing raises.

To flesh out the terminology behind these tables, we can roughly define loan types as falling into different categories (note, these categories are not mutually exclusive):

Syndicated deal	There is a lead bank that distributes or "syndicates" the deal to multiple debt investors. In the institutional market, banks will syndicate out revolving loans in addition to the term loans or other securities to banks, as well as non-bank institutional investors/bond investors.
Club deal	Similar to syndicated deal but the group is more tightly held amongst a few lenders, and often arranged by the client without a formal syndication process.
Privately placed deal	Placed by the client directly on a private basis (often for 2nd lien deals).
Direct lending deal	Directly held by one or a handful of investors (no syndication); often structured as a "Unitranche" loan (i.e. not split into senior secured and subordinated tranches, but combined into one tranche).
Bilateral deal	Held by one lender.

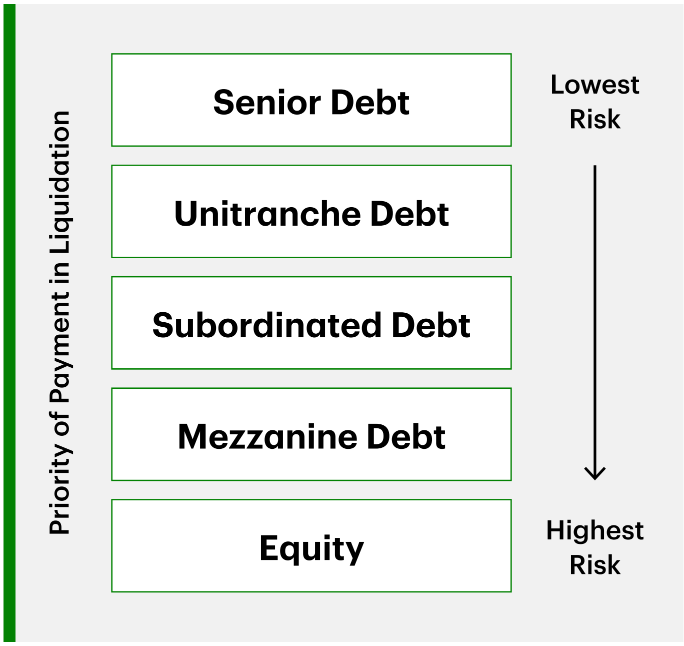
Furthermore, we can also break the types of execution of loan deals into broad categories:

Underwritten deal	Loan arrangers guarantee the entire commitment of proceeds to the borrower prior to syndicating the loan. Banks must be prepared to fund any amounts not syndicated, although arrangers often build in flexibility allowing them to change pricing / terms to the syndicate. Fully underwritten deals are more expensive to the borrower to compensate banks for the additional execution risk.
"Best-efforts" syndication	The loan arranger group will attempt to raise a specified financing package but are not required to deliver a pre-negotiated set of terms. Arrangers also not required to provide full amount of funds, meaning that there is increased execution risk for the borrower, but lower fees than underwritten financings.
Sponsor-Backed/Direct	This distinction characterizes whether a borrower's corporate entity is owned/fronted by a financial sponsor (a Private Equity manager) in their dealings with lenders, or if that corporate entity directly represents itself. Although 'Direct' deals give more negotiating power to lenders, the involvement of sophisticated 'Sponsors' brings a potential financial backstop for the corporate borrower in times of stress when Sponsors could support lending obligations.

Seniority & Priority in the Capital Stack

The different types of private credit transaction types detailed above explain the characteristics investors can expect from different classes of private credit. From a pure security and preservation of capital perspective, different private debt instruments give different priority in the capital stack if things go sideways. As detailed in **Figure 3**, from a seniority perspective, private credit can be decomposed into broad categories with differing legal provisions and priority of claims over the company's assets in a restructuring or bankruptcy.

Figure 3: The Capital Stack



Source: TD Asset Management Inc. As at June 30, 2025.

Unrated companies with business and financial profiles in the sub investment-grade realm, or rated companies below BBB-, can raise debt capital in the private credit, leveraged loan and/or high yield bond markets. Compared to traded loan markets (High Yield bonds or syndicated 'leveraged' loans), direct lending typically has a more conservative leverage profile and higher coupons in return for much less liquidity.

Direct lenders must mitigate credit risk through primary due diligence and benefit from collateral and covenants packages, in contrast to public fixed income markets where investors may rely upon an agent (like a rating agency) to conduct due diligence and ongoing credit monitoring.

Size Matters: Variations in the Private Credit Market

We can also define typical characteristics of the various lending solutions outlined above in a table to illustrate some of the strengths and weaknesses of the various categories or instruments in **Figure 4**:

Figure 4: Variations in the Private Credit Market

	Senior secured direct loans	Mezzanine Loans	Unitranche Loans	Broadly Syndicated Loans	High Yield Bonds
Expected Return	7.0%-11.0%	9.0%-15.0%	8.0%-12.0%	6.5%-9.0%	5.5%-8.0%
Basis of Coupon	Floating (SOFR + spread)	Floating (SOFR + spread)	Floating (SOFR + spread)	Floating (SOFR + spread)	Fixed rate
Borrower profile	Mid-market companies	Mid-market companies	Low to Mid-market companies	Mid-to-Larger companies	Larger/established companies
Risk Category	Moderate	High	Mod/High	Lower	High
Typical Covenants	Incurrence and maintenance	More limited (subordinated)	Incurrence and maintenance	Fewer given standardization	More modest (unsecured)
Liquidity	Low	Low	Low	Moderate	Higher
Collateral/ Seniority	Senior Secured	Subordinated/ limited collateral	Senior Secured	Secured	Mostly Unsecured
Maturity Tenor	3-7 years	3-7 years	3-7 years	5-10 years	5-10 years
Pricing Mechanisms	Manager or specialist 3rd party valuation	Manager or specialist 3rd party valuation	Manager or specialist 3rd party valuation	Trade-based or 3rd party valuations, less volatile than HY	Traded securities, reflect public rate and credit volatility

Source: PitchBook, Prequin, Bloomberg Finance L.P., TD Asset Management Inc. As at June 30, 2025.

Market

To bring **Figure 4** to life, we can characterize 'Direct Lending' loans (senior secured and unitranche loans) as typically floating rate, illiquid, senior secured loans with 5-to-7-year maturities. They often incorporate financial and legal covenants, which provide the lender with structural protections. Loans are held by a single or small group of lenders, which streamlines decision-making from both **(i) a speed/flexibility of issuance perspective**, and **(ii) power and decision making if troubled situations arise**. Direct loans also limit the disclosure of potentially sensitive borrower financial and strategic information. Loans to companies with so-called Private Equity 'sponsors' finance private equity buyouts, leveraged buyouts, dividend recapitalizations, acquisitions and corporate expansions. Debt capital raises can be similarly used by independent ('non-sponsor-backed') private companies, although those loans are considered slightly riskier given they lack the expertise and implicit support of a deep-pocketed sponsor.

Private credit strategies can range in seniority and return. A focus on balance sheet seniority would emphasize 'capital preservation' areas like Broadly Syndicated Loans or more direct sponsor-focused first-lien loans that seek to deliver predictable returns. Such strategies would preside in the alternative/credit investor allocation spectrum. Riskier 'return maximization' strategies could feature less senior 'second-lien' or 'mezzanine' loans, or move into specialty areas like distressed credit or opportunistic credit. Return maximizing strategies and mandates would provide opportunities for capital appreciation and feature the prospect for outsized returns. Their greater risk means investors may need to classify such credit investments as veering into private equity or other return-seeking allocation areas.

Another way of distinguishing different types of private loans would come from the size of the borrowing entity. This comparison is shown in **Figure 5**, where the size of the borrower determines typical lending conditions. Different sized corporates can issue different types of securities – for example, a core middle market corporate could issue both a senior secured first-lien tranche as well as a mezzanine tranche – but the borrower's size and risk of its cash flows will determine whether terms achieve the high (or low) end of the range for a specific lending solution.

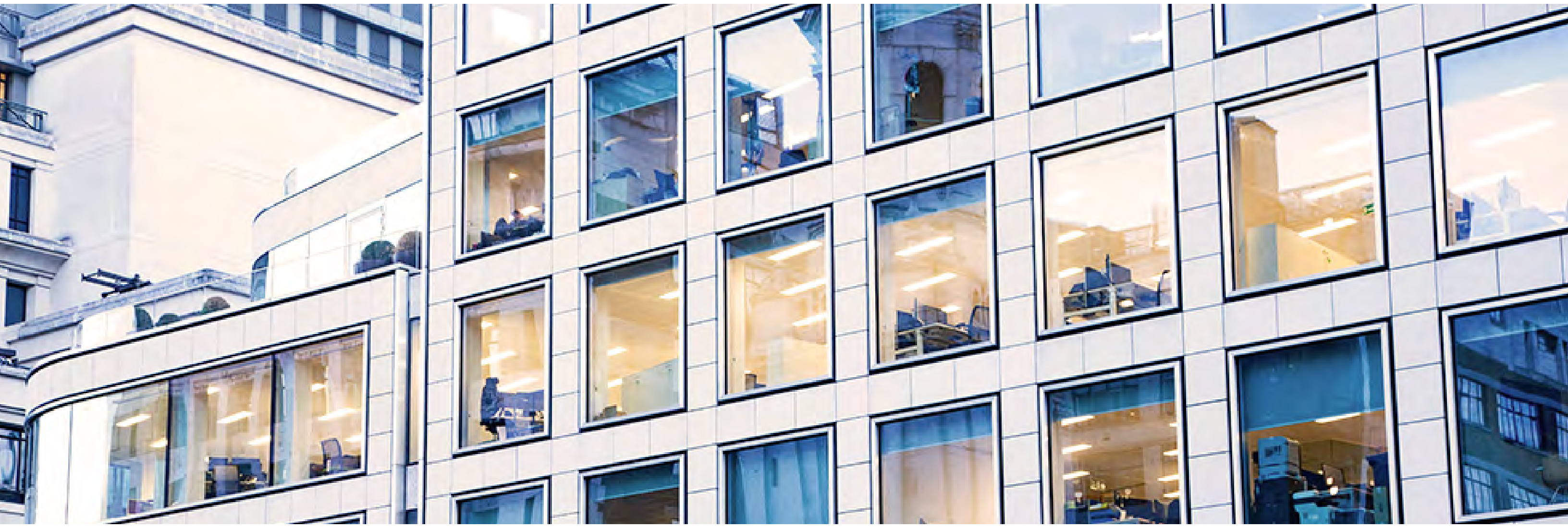
Figure 5: Typical Corporate Borrower Profile

	Lower Middle Market	Core Middle Market	Broadly Syndicated
Borrower/Lenders:			
Typical Lenders	Small clubs: BDCs & Direct Lenders (1 to 3)	Clubs of: Direct Lenders, BDCs, Selected Funds (2 to 10)	Commercial Banks, Regional Banks, CLOs, Some Funds (multiple)
Loan Facility Size	Below ~$100 million	$100 to $200 million	Above $200 million
Co. cash flows (EBITDA)	$5 to $20 million	$25 to $75 million	Above $75 to $100 million
Return Expectations:			
Spread levels	400 to 750 bps (SOFR+)	350 to 700 bps (SOFR+)	250 to 500 (SOFR+)
Expected yield	8.0% to 11.5%	7.5% to 11.0%	6.5% to 9.0%
Risk Metrics:			
Historical Default Rates	0% to 8% (typically 2-4%)	0% to 8% (typically 3-4%)	0% to 8% (typically 2-4%)
Historical Recovery Rates	Greater than 75%	Greater than 70%	Greater than 40%
Debt Multiple Range	2.0 to 4.5x Debt/EBITDA	3.0 to 5.5x Debt/EBITDA	Less than 6.5x Debt/EBITDA
Typical Loan-to-Value	35% to 45%	35% to 50%	45% to 65%

Source: PitchBook, Prequin, Bloomberg Finance L.P., TD Asset Management Inc. As at June 30, 2025.

Therefore, there will be generous overlap between the different ways that **Figure 4** and **Figure 5** characterize a borrower – for example, a large, well-known private corporate will be much more likely to move into the Broadly Syndicated ("BSL") market, and a small non-sponsor-backed company will not be granted access to the BSL or High Yield markets. As size (based on EBITDA) of the borrower falls, lender power to demand higher spreads and impose legal covenants grows considerably, under the premise that small enterprises have greater default risk (a perception not always supported by the data). Furthermore, global lending giants with considerable capital to deploy are highly incented to 'scale' their efforts by targeting larger loan size.

At the highest private level, Broadly Syndicated Loans are the domain of larger borrowers who have more size, financial infrastructure and a lender following that permits more standardized terms and tighter spreads. Broadly syndicated loans also comprise the collateral for most Collateralized Loan Obligations ("CLOs"), which are purchased by CLO managers through primary bank syndications or from an active secondary market. CLOs are a securitized product/vehicle where financial assets (household or corporate loans) are pooled together and sliced into varied risk and return tranches. As such BSLs form a bedrock of assets in the global CLO market that is worth more than $1 trillion as of June 30, 2024.



Recent Developments: Lending Platforms Challenging Banks

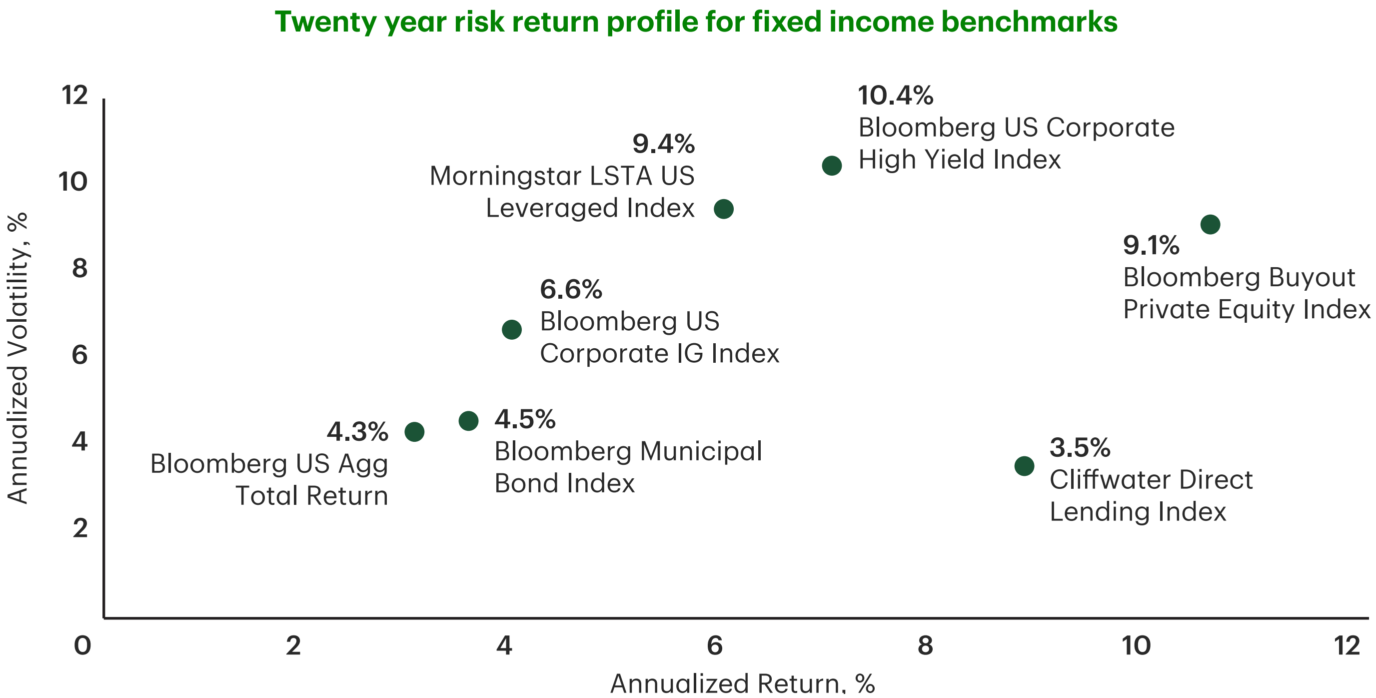
The BSL loan market and upper middle market is where Credit Managers, often in conjunction with Sovereign Wealth Funds or sophisticated government-sponsored pension plans, are challenging Regional and Commercial Banks in the arrangement and 'club' syndication of private deals. Borrowers are willing to stomach slightly higher coupons in return for customized flexibility and speed and certainty of execution. This 'disintermediation' of roles traditionally filled by bank desks, reflects the growing size and sophistication of direct lending managers and the maturation of their relationships with Private Equity sponsor groups. In fact, Private Equity Sponsors and private lenders are increasingly housed under the same manager organizational umbrella. This dynamic has elicited different reactions from the banking community seeking to protect their lending franchise and exclusive relationships with small and medium sized enterprises (SMEs) that are very large collective issuers of subgrade credit. Banks have deep relationships with serial lenders, as well as the credit expertise to perform due diligence and structure loans. Their traditional role as loan arrangers (and not principal investors), however, has meant they require a longer marketing and book-build period with capital providers. Banks have recently sought to build relationships with private credit firms or internal asset management subsidiaries so they could better compete. The evolution of this "frenemy" ecosystem between banks and the direct lending community will likely prove both interesting and provide even better choice to institutions looking to allocate capital to the asset class.

Recent Market Experience – Performance Matters

Another reason for direct lending's rapid growth has been performance. As shown in **Figure 6.1**, over the last two decades Direct Lending has produced handsome returns. The non-traded nature of direct loans also means they are not marked frequently and can therefore make a claim of showing less significant volatility.[3] This is especially beneficial over long time horizons and helps stabilize total portfolio throughout various market environments and conditions as shown in **Figure 6.2**.

This excellent performance has helped the exponential growth of the Private Credit market, which most market participants expect to continue.

Figure 6.1: Direct Lending Returns and Figure 6.2: Returns by Asset Class



Market Condition	Year	Direct Loans	Syndicated Bank Loans	High Yield	Investment Grade Corporates
Rising rates	2005	10.1%	5.1%	2.7%	1.7%
Rising rates	2006	13.7%	6.7%	11.8%	4.3%
Stability	2007	10.2%	2.1%	1.9%	4.6%
Recession	2008	-6.5%	-29.1%	-26.2%	-4.9%
Recovery	2009	13.2%	51.6%	58.2%	18.7%
Rising rates	2017	8.6%	4.1%	7.5%	6.4%
Rising rates	2018	8.1%	0.4%	-2.1%	-2.5%
Stability	2019	9.0%	8.6%	14.3%	14.5%
Recession	2020	5.5%	3.1%	7.1%	9.9%
Recovery	2021	12.8%	5.2%	5.3%	-1.0%
Rising rates	2022	6.3%	-0.8%	-11.2%	-15.8%
Rising rates	2023	5.6%	13.3%	13.4%	8.5%

Total Return from Sep 2004 through June 2024, Cliffwater Direct Lending index returns and volatility through June 2023.
Source: Bloomberg Finance L.P.

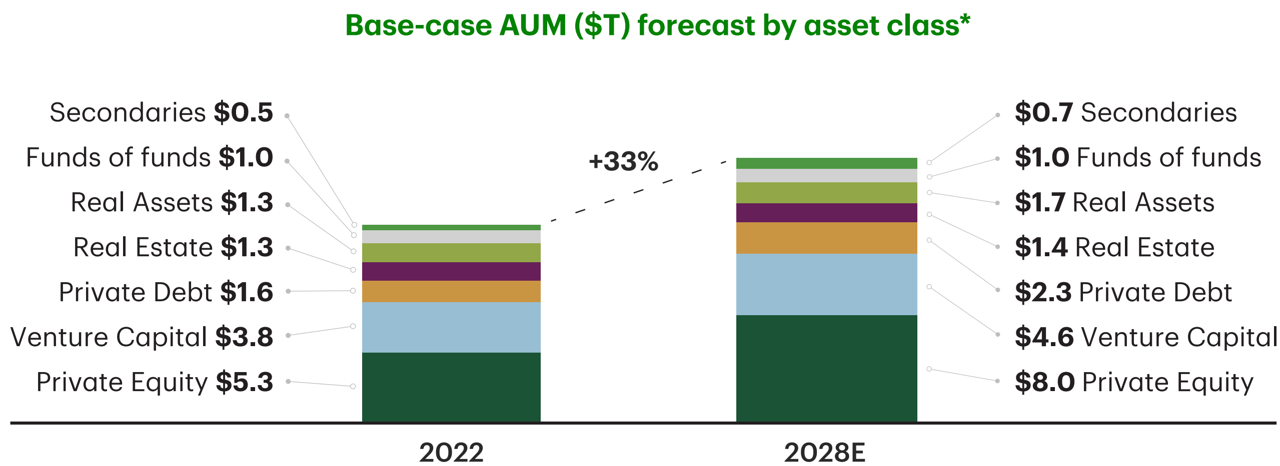
[3] Many Direct Lenders hold loans at book or book + accrued value (unless they experience material impairment), due largely to the floating rate nature of direct loans, resulting in lower volatility than public credit.

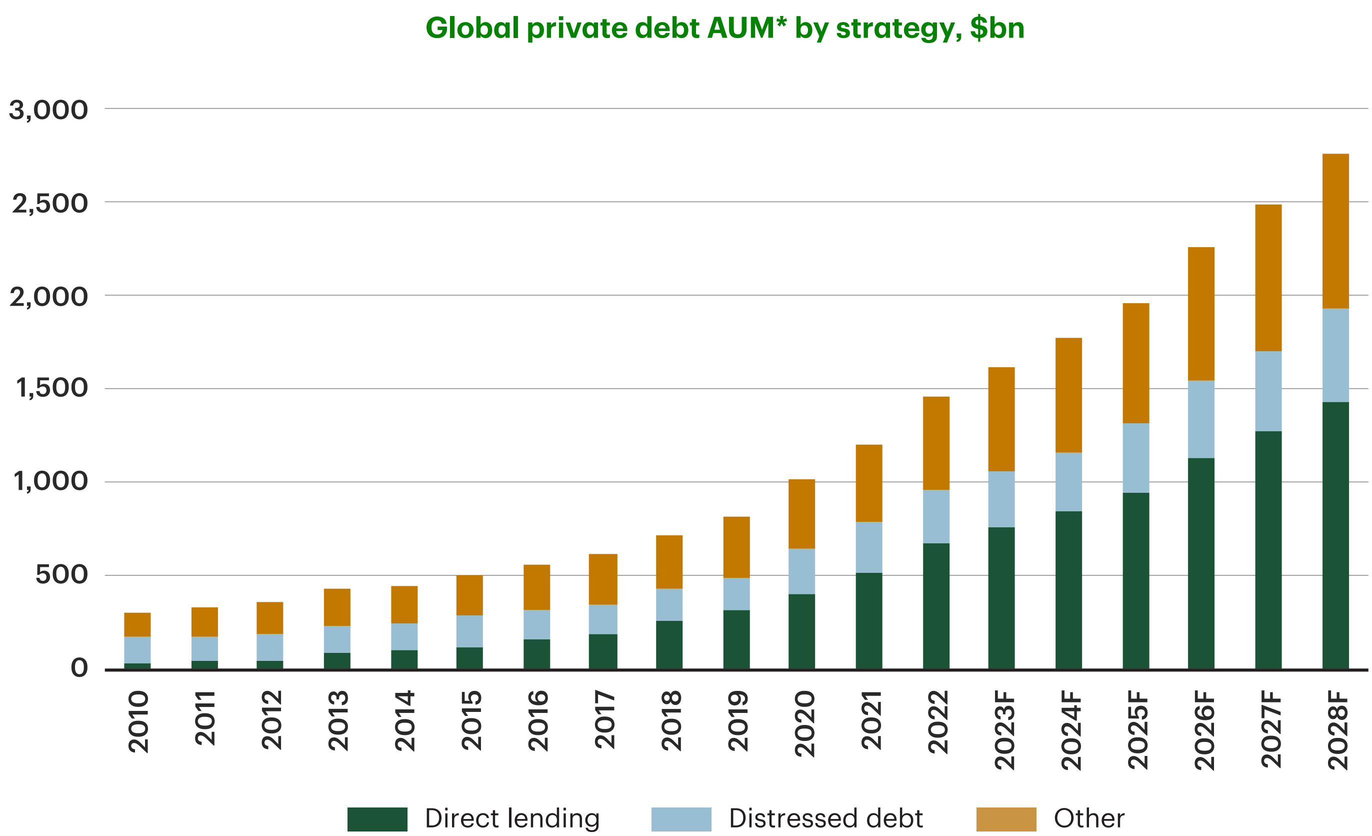
Outlook: The Road Ahead

As shown in **Figure 7.1**, growth is expected to continue on a rapid trajectory. Why? Foremost is the evolution of the private equity ecosphere. As shown in **Figure 7.2** below, PitchBook projections see PE assets under management moving from over US$5.0 Trillion to US$8.0 Trillion by 2028 – a substantial portion of which will result from 'dry powder' to be deployed to unearth significant credit origination opportunities. Secondly, the greater willingness of Direct Lenders to supply capital to non-sponsored SME corporates means vast opportunities as such corporates find a new form of growth capital previously not addressed by more conservative bank lending models.

These dynamics have PitchBook forecasting private credit growing from the current $1.6 trillion to $2.8 trillion by 2028.

Figure 7.1 and 7.2: Growth Projections





Source: PitchBook. Geography: Global. *Historical AUM and forecasts generated on April 19, 2024.

Private credit

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