



January 2024

FIND THE GAP

The Case for Specialty Private Credit

EXECUTIVE SUMMARY

The growth of the private credit space has been one of the most notable stories in the alternative investment management industry over the 10-plus years following the Global Financial Crisis (“GFC”). This comes against the broader upward trend in risk-asset valuations and capital allocators’ recognition of the challenges associated with constructing portfolios that can both meet stated return objectives and adequately control for risk.¹ In this paper, we highlight what we believe is a powerful tool consistent with investors’ demand for private credit in that context: allocating to “specialty” or “asset-based” private credit.

Herein, we will explore the merits of and implementation considerations for adding specialty private credit to investment portfolios, with a focus on the following key topics:

- **The Evolution of Private Credit:** The growth and current composition of the private credit space is placed in the context of the broader economy as well as other, more mature, private market asset classes.
- **Defining Specialty Private Credit:** We outline and explore the relative merits of specialty private credit’s various asset types and cashflow profiles.
- **“Financing Gaps” and Why They Exist:** We discuss the existence and causes of material “financing gaps” in credit markets, which we believe present opportunities for skilled specialty private credit managers to earn yields in excess of publicly traded credit of comparable quality.
- **Filling the Gaps—Considerations When Accessing Specialty Private Credit:** A brief review of implementation considerations when accessing the specialty private credit space.
- **Looking Ahead—The Opportunity in U.S. Bank Deleveraging:** Finally, we touch on how current dynamics in the U.S. banking sector are creating opportunities for specialty private credit investors – a topic we will further expand upon in the next piece in our “Asset-Based Credit: The Post-Bank Era” series.

THE EVOLUTION OF PRIVATE CREDIT

Over the past 10 years, many investors have broadened their acceptance of illiquidity within their portfolios beyond traditional private equity and real estate allocations.² Potential drivers of this trend include the wealth of credit-related investment opportunities subsequent to the GFC, as well as the reduction in forward-looking return expectations for traditional asset classes.³ One notable consequence of this broader acceptance of illiquidity has been the rapid growth in fundraising for private credit strategies, which have grown from \$726 billion in global assets under management in 2010 to approximately \$1.6 trillion in 2023. Further, surveys of market observers and participants suggest that a majority of allocators globally intend to increase or significantly increase their allocations to the space, resulting in an expected \$2.8 trillion in private credit assets under management by 2028 (Figure 1).⁴ One notable feature of this remarkable growth trend for private credit has been the general emphasis on corporate credit. Per Figure 2, **corporate credit-oriented strategies across direct lending, mezzanine, venture, and distressed debt represented more than 80% of global private credit AUM as of 2023.**⁵

Figure 1: Global Private Credit AUM

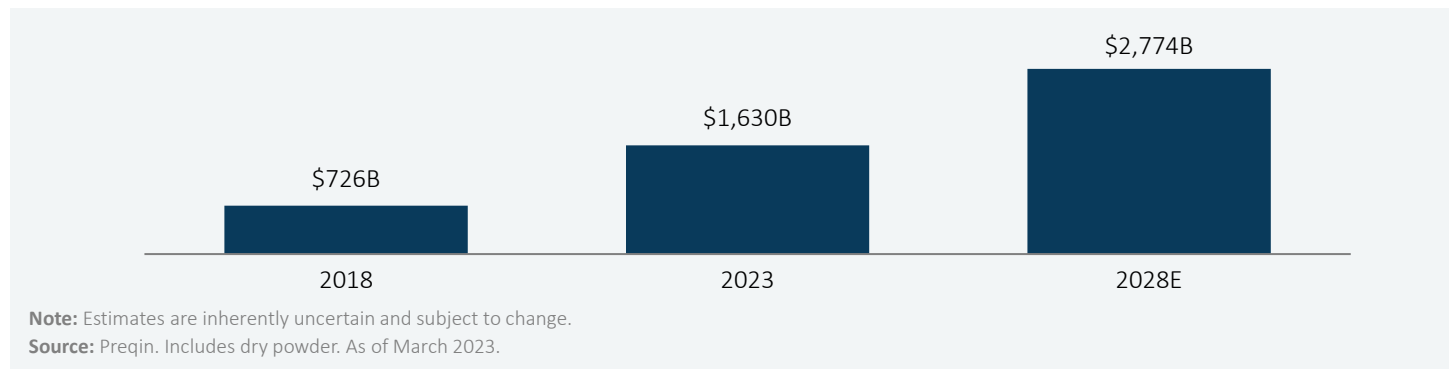


Figure 2: Private Credit AUM

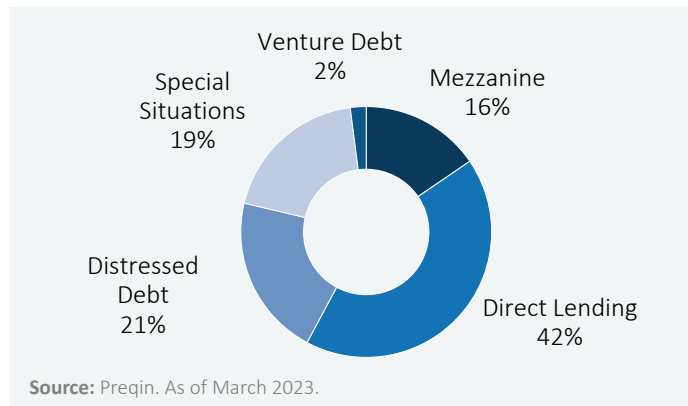
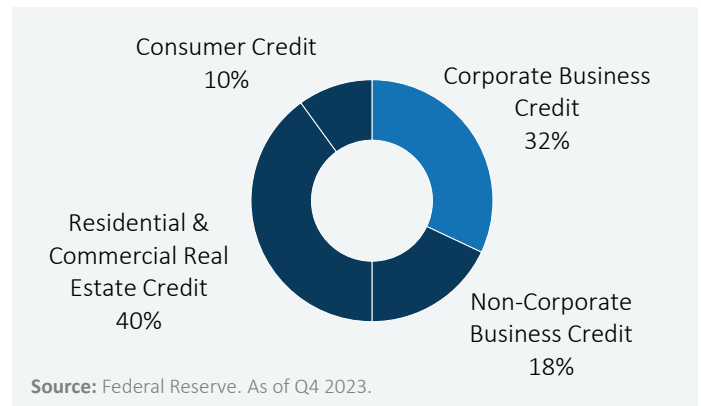


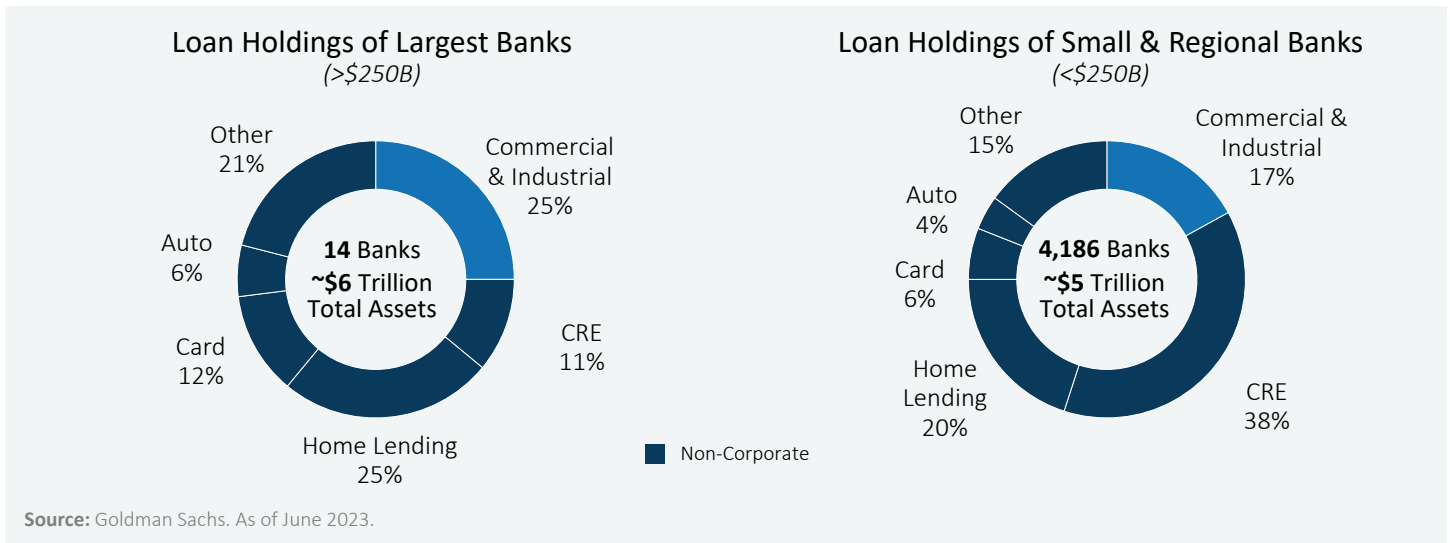
Figure 3: Total U.S. Non-Financial Credit



Private Credit = Funds as Balance Sheet Lenders...But to Which Borrowers?

For their targeted borrowers, the growth and proliferation of private credit funds has served to supplement or even replace the need for financing from traditional commercial banks. In other words, private credit funds allow their investors to play the role of the traditional banking system. However, this raises the question: **Is the current private credit fund universe representative of the full spectrum of lending opportunities?** Figure 3 displays the U.S. Federal Reserve's measure of aggregate U.S. non-financial business and household credit. As is illustrated therein, less than one-third of credit in the United States is comprised of corporate business credit.

Figure 4: U.S. Banks Largely Own Non-Corporate Credit



Further, in Figure 4, we illustrate the breakdown of both large and small/medium banks' loan holdings, with commercial & industrial lending comprising only 25% and 17% of these banks' respective holdings. In short, banks don't generally own corporate credit in the same proportion that the private credit fund universe currently appears to. With this in mind, we believe an economically representative, "bank-like" exposure to the U.S. economy would be materially different from the holdings currently represented in a typical investor's private credit portfolio. **In other words, there is still a lot more credit beyond what private credit funds have accessed to date!**

Let's Talk About Fundamentals

Given that many of the non-corporate categories of lending are household-related, it is important to note that credit fundamentals for U.S. households have been consistently improving over the past decade. Per Figures 5, 6, and 7, the trends in household balance sheets compare favorably to those for corporate credit in the United States, where a variety of quality measures have declined notably over the past ten years.

Figure 5: U.S. Business & Household Debt Outstanding

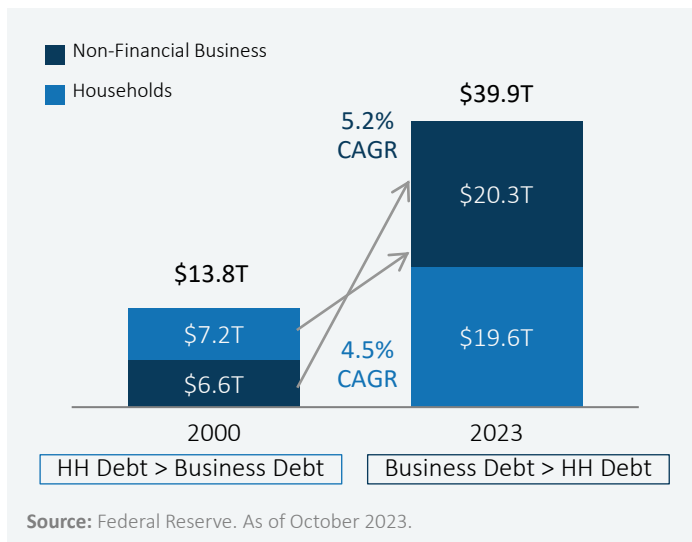
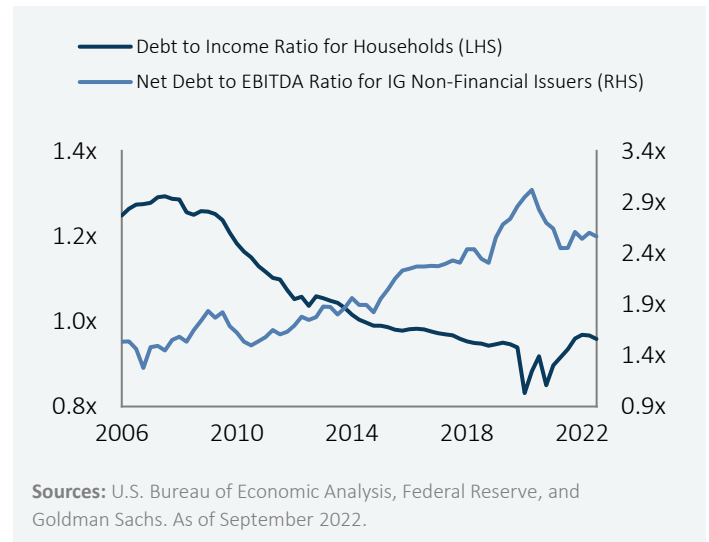
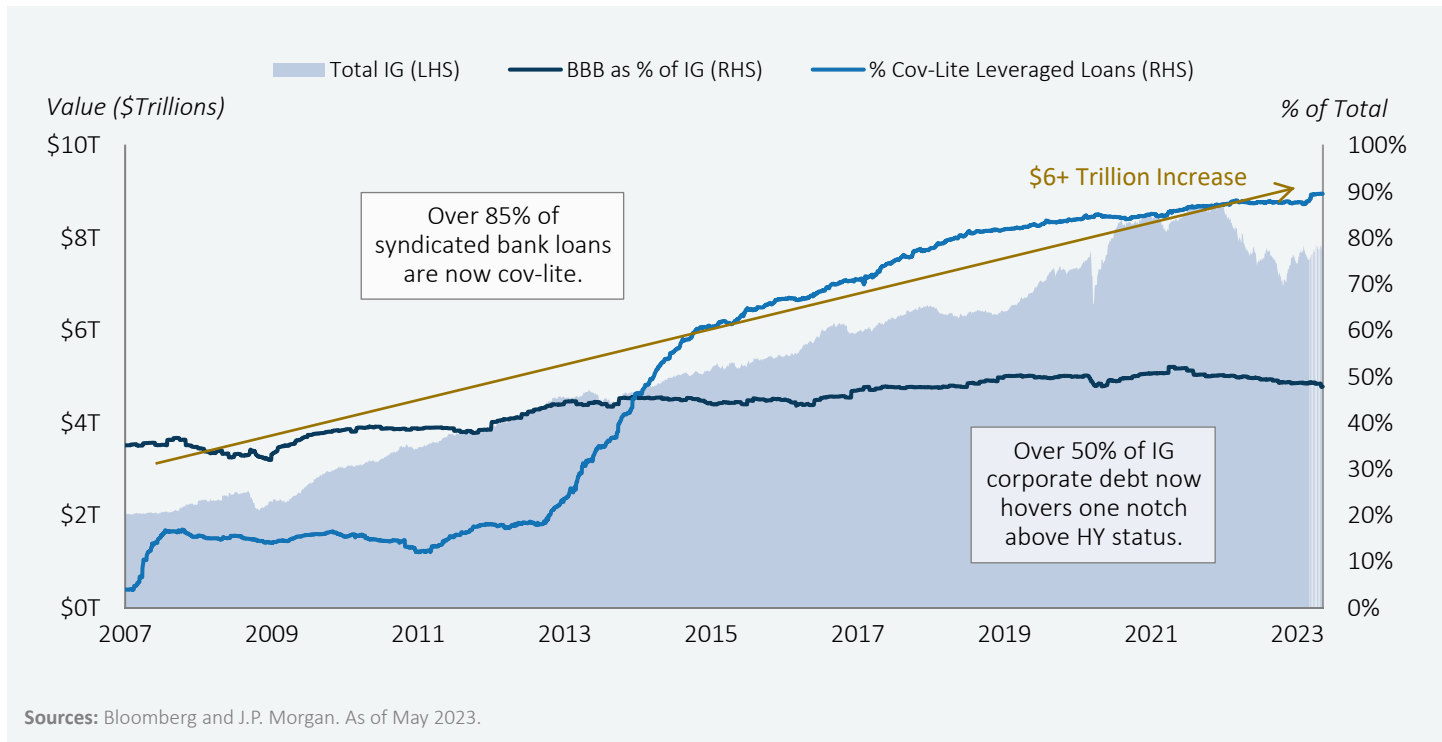


Figure 6: Household & Corporate Leverage Diverging



Specifically, household leverage has decreased by approximately 25% since 2006, while aggregate corporate leverage has increased by approximately 70%. This deterioration in corporate credit quality has been particularly noticeable within the investment grade (IG) space, where the proportion of IG debt rated one notch above junk (BBB) has increased 36% since 2006.

Figure 7: U.S. IG Outstanding and BBB & Cov-Lite as % of Totals



Where Do We Go From Here?

With the aforementioned context in mind, it is worth considering what a mature, high-quality private credit portfolio might look like in the future. With the development of institutional private equity portfolios as a guide, we would expect that, as private markets mature, capital allocators will refine their portfolio construction approaches to include additional sub-strategies to serve different portfolio needs. One such example is private equity secondaries, which can serve as a j-curve or duration mitigant and can act as a source of liquidity for limited partners with portfolio rebalancing needs. In the context of a lending portfolio, as we will discuss in more detail in subsequent sections of this paper, increasing the diversity of obligors and asset types can be a powerful way to mitigate downside risk.

As noted previously, we believe exposure to a broad set of credit assets spanning corporate, non-corporate, and household forms of debt should increase diversification, provide a more representative exposure to the overall economy, and offer access to sectors with improving relative fundamentals. Perhaps most importantly, we believe skilled, active management coupled with the appropriate private markets sourcing capabilities and advanced infrastructure can enable private credit managers to extract material premiums relative to publicly-traded, non-corporate credit. **We refer to this emerging private credit space as “specialty private credit” and will devote the balance of this paper to exploring the attributes of such strategies as well as implementation considerations for investors.**

DEFINING SPECIALTY PRIVATE CREDIT

Asset Types



Consumer

- Consumer Loans
- Credit Cards
- Student Loans
- Auto Loans



Real Asset

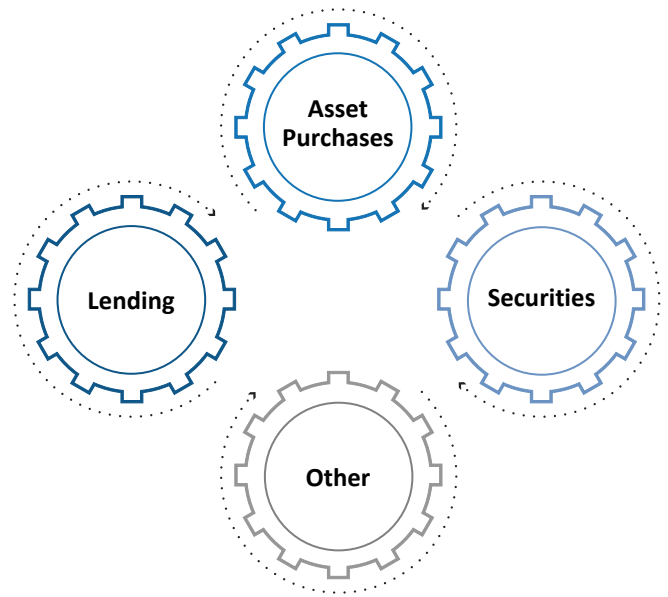
- Residential Non-QM, RPL
- Single-Family Rental
- Residential Development
- CRE Construction, Bridge
- Multi-Family



Specialty

- Equipment Leases
- Small Business Loans
- Merchant Cash Advances
- Royalty Streams
- Capital Relief

Transaction Mechanisms



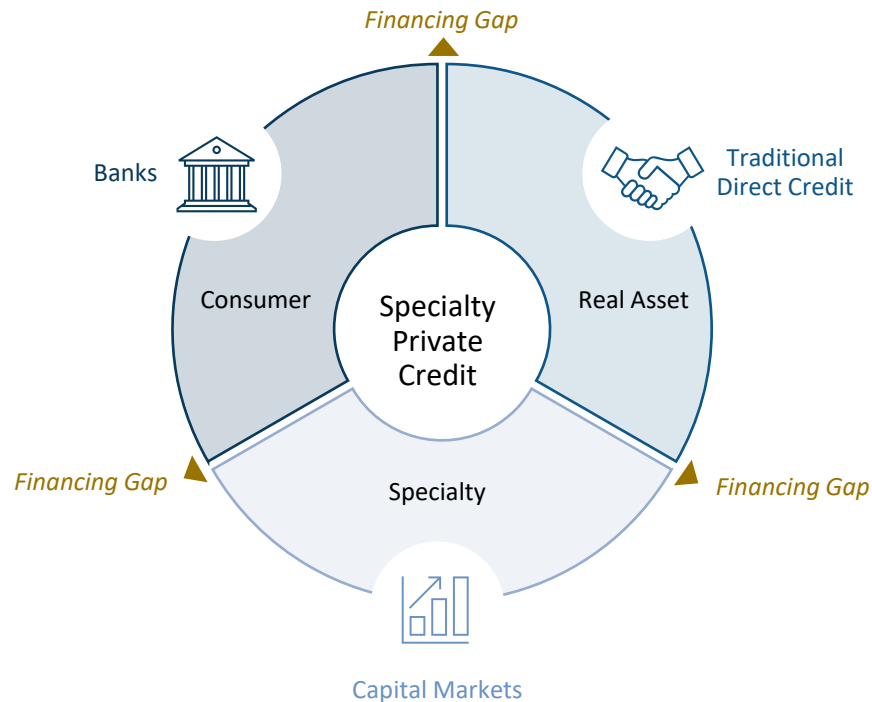
Regardless of the specific asset type, specialty private credit investments share a number of important features and characteristics. For example, each investment is secured by real or financial assets that generate cashflows throughout the life of the investment for repayment. Another notable feature of the specialty private credit space is the sheer size of the potential opportunity set. As illustrated in Figure 8, the variety of individual asset-based financing markets is such that, in aggregate, the total addressable market (TAM) of approximately \$8 trillion appears large in comparison to the current assets under management in “conventional” private credit and comparable to the relatively more mature private equity space.

Figure 8: Substantial Addressable Market



“FINANCING GAPS” AND WHY THEY EXIST

Another noteworthy feature of specialty private credit markets is that compelling opportunities often exist in between domains occupied by traditional market participants or asset types, as illustrated below.



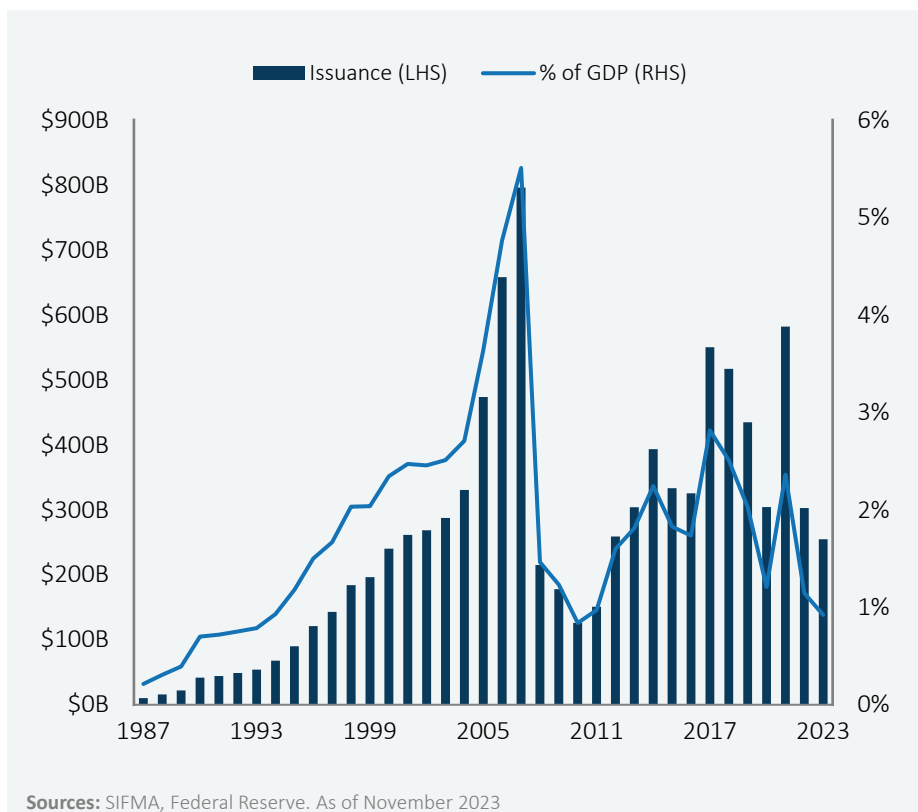
Traditional market participants have historically included banks, ratings agencies, and buyers of IG structured credit bonds. Key features of the assets favored by these traditional market participants include homogeneity and a long history of data on which to base their underwriting decisions, to name just two. In theory, efficient credit markets should quickly match debt capital to creditworthy borrowers at yields commensurate with their credit risk. Inefficiencies – or “gaps” – arise when a particular asset type or situation exhibits complexity or newness that challenges the existing frameworks used by traditional market participants, thereby limiting their ability to participate. We believe specialty private credit managers that have the wherewithal to lend into those gaps have the potential to therefore extract yields in excess of those more efficient markets.

One consistent source of disruption within even well-established financing markets over the past decade has been the financial technology sector, which has produced innovations across a variety of lending markets.⁷ Another driver of change has been pressure on the availability of capital from traditional market participants; as illustrated in Figures 9 and 10, banks have faced increased regulatory pressure and issuance has declined in asset-backed capital markets. Finally, both capital markets and banking system-related dislocations can also cause “gaps” to proliferate, which alternative lenders can play a role in filling; these forces appear particularly strong in the current market environment, and we will further expand on that dynamic in this paper as well as upcoming publications.

Figure 9: Illustrative Regulations



Figure 10: Total U.S. ABS Issuance (\$ Billions)



FILLING THE GAPS

Considerations When Accessing Specialty Private Credit

The financing gaps we have described represent an unmet need for lending to support creditworthy economic activities. Provided a manager can safely deploy capital into those gaps, these inefficiencies can represent compelling investment opportunities for private credit investors. Furthermore, we believe there are aspects of specialty private credit that have many advantageous risk attributes in the context of broader private credit portfolios.

Risk Attributes: Front Loaded Cashflow, Diversity & The Law of Large Numbers, and Structuring

There are several key attributes of specialty private credit assets that we believe can have a beneficial impact on risk measures. For example, in Figure 11 we have charted the yearly expected cashflows for several core specialty private credit asset types, which shows that most of the aggregate projected cashflows are weighted toward the early years of those assets’ total expected lives. The rapidly amortizing nature of these cashflows allows specialty private credit lenders to get paid back in a shorter period of time, thereby potentially mitigating the risk of those lending exposures faster than investments that rely on a large exit event or refinancing to receive the bulk of invested capital and profits—such as private equity or conventional high yield bonds.⁸

Another key aspect of specialty private credit assets – which are frequently comprised of large numbers of individual loans, such as pools of mortgages or consumer debt – is the impact on statistically modeled downside tail risk as the number of individual loans in a pool increases. As illustrated in Figure 12, while the mean expected return generally holds constant, the one-in-twenty downside outcome – represented by the first to fifth percentile bar – is dramatically bounded as a hypothetical portfolio of loans is taken from 15 to 500 individual loans. While the benefits of diversification are a well-established aspect of modern portfolio theory,⁹ we believe this asymmetric downside protection is particularly important for par lending strategies where the upside for any particular position or portfolio is somewhat limited. Notably, we believe this dynamic holds true for both specialty private credit assets themselves and at the portfolio level, as broader private credit portfolios can potentially benefit from the addition of diversified sources of cashflow like non-EBITDA related specialty private credit.

In other words, diversity and the law of large numbers are both reasons to include specialty private credit in portfolios and dynamics that can be readily achieved in the investments themselves.

In addition to the intrinsically appealing asset-level attributes of many specialty private credit assets, it is important to note that skilled specialty private credit managers have a variety of tools intended to generate diversification and downside protection at the deal level. Specifically, transactions are generally heavily structured with a focus on control and the preservation of principal through features that emphasize rigorous asset surveillance, early warning, and loss mitigation mechanisms. A sampling of such tools, which are born out of practices that commonly appear in the structures of publicly traded asset-backed securities, include the following:

- ✓ Security from discrete hard or financial assets that function as collateral
- ✓ Ring fenced structures that hold the relevant collateral
- ✓ Regular cashflow sweeps
- ✓ Performance-based deleveraging triggers
- ✓ Affirmative and negative covenants
- ✓ Control of assets and/or ability to foreclose
- ✓ Active servicing and asset management
- ✓ Early warning signals from daily collateral surveillance

Therefore, while specialty private credit investments are generally secured by assets, they can also benefit from covenants and other structural protections.

Figure 11: Illustrative Cashflow Profiles

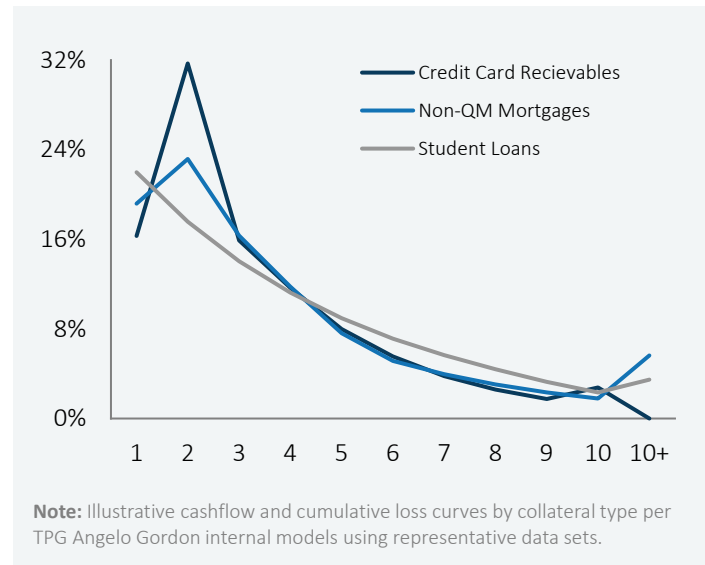
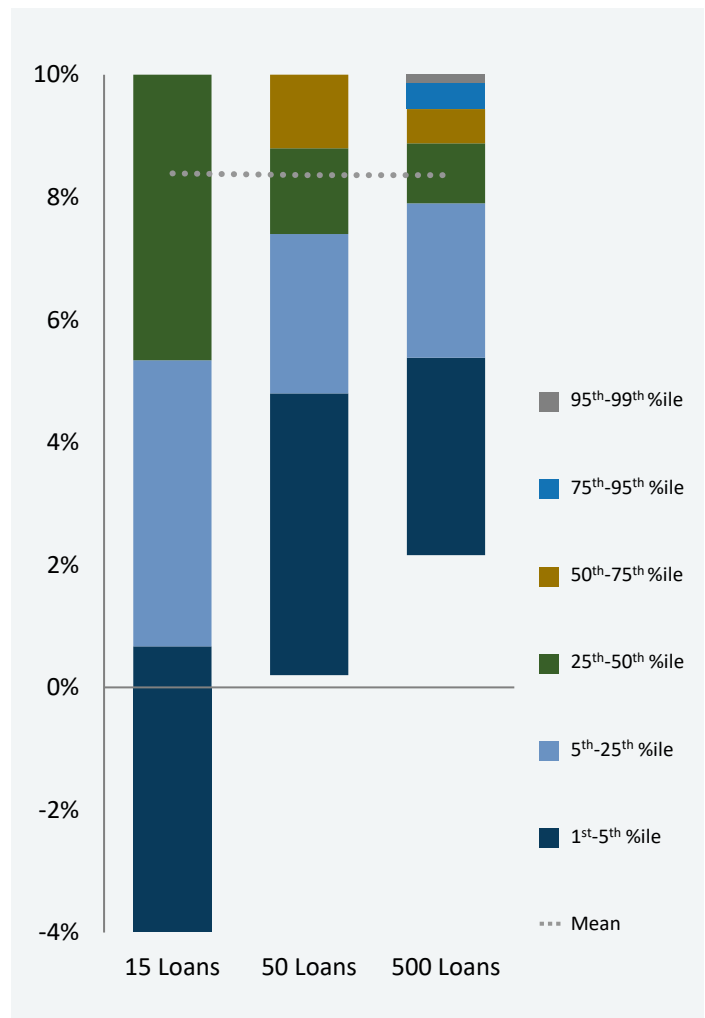
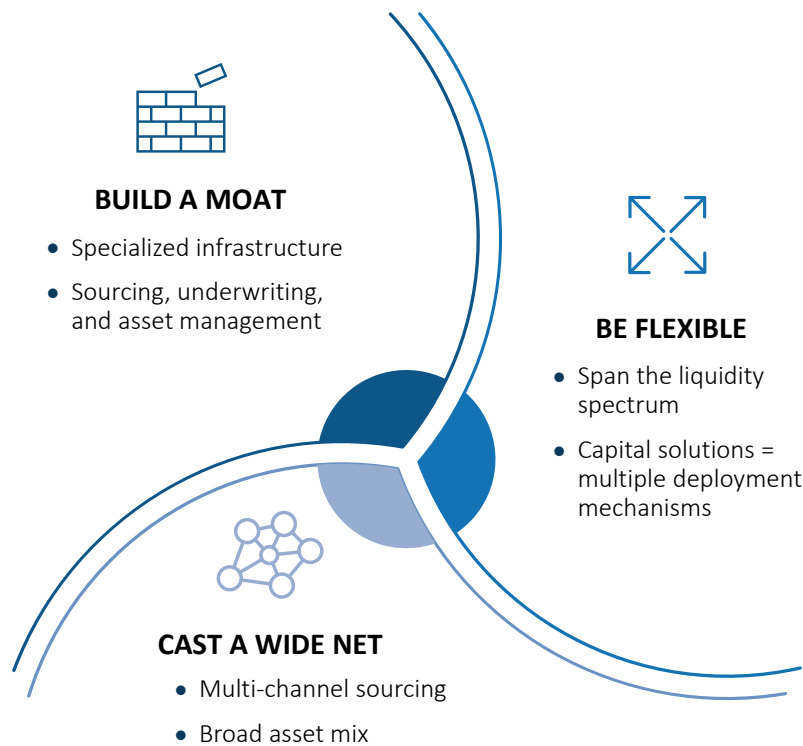


Figure 12: Distribution of Outcomes at Varying Position Counts¹⁰



Implementation Considerations: Build a Moat, Be Flexible, and Cast a Wide Net

There are a wide variety of specialty private credit asset types, as well as a complex and constantly evolving set of forces that impact and occasionally impair the efficient matching of lenders and borrowers in non-corporate financing markets. Given that rigidity from traditional market participants may be a source of inefficient pricing, investors should consider identifying alternative lenders that employ flexible, opportunistic approaches in order to fill financing gaps across the liquidity spectrum while still maintaining high underwriting standards. In addition, there can be more analytical and operational complexity to specialty private credit investments, thus significant, specialized infrastructure may be required in order to effectively execute on such opportunities. With this in mind, we believe investors should consider managers that have invested in this “moat” around their specialty private credit investment engines.



LOOKING AHEAD: THE OPPORTUNITY IN U.S. BANK DELEVERAGING

As noted previously, banks have historically played a significant part in non-corporate lending in the United States. Further, disruptive change has historically produced financing gaps around those lending markets that may present compelling investment opportunities for private credit investors and skilled specialty private credit managers. As of this paper’s publication, a combination of forces – including interest rate volatility, bank failures, and prospective regulation – have combined to produce a particularly acute period of disruption for the U.S. banking system. As such, we will devote the next paper in our “Asset-Based Credit: The Post-Bank Era” series to this topic, with a specific focus on the opportunities we believe these dynamics may offer specialty private credit investors.

THE CASE FOR SPECIALTY PRIVATE CREDIT

In conclusion, when it comes to the merits of and implementation considerations for allocating to specialty private credit, there are several of key points to keep in mind:

The Evolution of Private Credit

- Private credit has grown rapidly over the past 10 years, and global private credit assets under management are expected to reach \$2.8 trillion by 2028; however, currently, the preponderance of private debt assets under management appear to be corporate debt.

Defining Specialty Private Credit

- We believe there are a number of compelling reasons to include non-corporate forms of lending in a mature private corporate portfolio, including but not limited to:
 - the potential downside-mitigating effects of diversity in any lending portfolio,
 - the large size and economic relevance of non-corporate forms of lending, and
 - the relatively improving fundamentals of certain specialty credit borrower cohorts – such as U.S. households – versus corporates.

“Financing Gaps” and Why They Exist

- A noteworthy feature of specialty private credit markets is that compelling opportunities often exist in between domains occupied by traditional market participants or asset types. We believe these material “financing gaps” arise when a particular asset type or situation exhibits complexity or newness that challenges the existing frameworks used by traditional market participants, and can present opportunities for skilled specialty private credit managers to earn yields in excess of publicly traded credit of comparable quality.

Filling the Gaps—Considerations When Accessing Specialty Private Credit

- The underlying assets in specialty private credit investments offer a number of compelling risk attributes, and there are a variety of benefits associated with the transaction structures employed by specialty private credit lenders. When it comes to allocating to specialty private credit, investors may wish to consider specialty private credit managers that employ flexible, opportunistic approaches and have strong moats around their capabilities, which support their abilities to access financing gaps.

Looking Ahead—The Opportunity in U.S. Bank Deleveraging

- We believe the ongoing, disruptive change being experienced in the U.S. banking sector appears to offer a particularly compelling entry point into the specialty private credit space, which is a topic we will further expand upon in the next piece in our “Asset-Based Credit: The Post-Bank Era” series.

ENDNOTES

1. Aon Asset Allocation, “Quarterly Investment Outlook”, August 2023; “Capital Markets Assumptions”, Q4 2022; “AA View: Rate Cuts Ahead?”, November 2023.
2. Preqin as of Q4 2023.
3. Rocaton Investment Advisors, “Alternative Credit: The Pursuit of Attractive Returns in a Late Cycle Environment”, February 2019.
4. Preqin, “The Future of Alternatives 2028”, November 2023.
5. Preqin as of Q4 2023.
6. Blackstone Strategic Partners Fund Solutions, “Primer for Today’s Secondary Private Equity Market”, Fall 2017.
7. MSCI Thematic Insights “Fintech Innovation: The transformation of financial services through technology” (2020)
8. No investment strategy can eliminate the risk of loss or guarantee returns in any market environment.
9. <https://money.usnews.com/investing/investing-101/articles/why-diversification-is-important-in-investing>. Diversification does not eliminate the risk of market loss.
10. TPG Angelo Gordon model output for simulated returns on an illustrative, generic performing loan pool using lognormal loan-level default distribution with a median of 1.4% and a 99th percentile of 15%, 10% yield, 60% severity and 0.5 intra-portfolio correlation between loan outcomes. This output does not represent a prediction, projection or hypothetical return of any fund asset class. Intended to illustrate the distribution of outcomes for capped upside par lending investments, generally.
Cashflow profiles and cumulative loss curves by collateral types shown in Figure 12 are for key credit asset types in scope for TPG AG’s specialty private credit strategy and which we believe to be generally illustrative of the types of cashflow profile which is observed, and loss curve analysis which is performed by TPG AG, in the context of prosecuting our specialty private credit strategy. Underlying data was sourced from TPG AG structured credit portfolio management and research systems (RPM, WOPR, Alpha, MINT) as of March 2020 and is available for your review upon request. Internal modeling assumptions reflect interest rates and other pertinent macroeconomic variables such as home price appreciation, unemployment, etc. The assumptions are based on the portfolio management team’s subjective judgment and may not be accurate. Actual investments may vary materially from the data shown in Figure 12.

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