

# Private Credit Primer

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By: Eric Elbell, CFA, CAIA

## Introduction

Private credit has emerged as a common part of the investment landscape in recent years as an increasing number of investors have embraced the asset class. Those yet to take the plunge may be wondering what the fuss is about and whether private credit merits a place in their portfolio. While its emergence as a distinct asset class is relatively new, private credit encompasses a range of investment strategies that have long been pursued by various capital providers. In this paper, we will explain what private credit is, detail its growth, identify its benefits and risks, and share some thoughts for how investors may consider incorporating it into a broad portfolio.

## Private Credit Defined

Generally speaking, private credit refers to the provision of loans directly to borrowers by a small group of lenders (or in some cases a single lender) who, in most cases, hold the loans until maturity. In this sense, private credit is distinguished from corporate debt instruments that are issued to the public and traded in liquid markets on a daily basis, such as investment-grade corporate bonds, high-yield bonds, and leveraged loans. In addition, in contrast to public debt issuers, a predominant portion of private credit borrowers are small- and mid-sized companies.<sup>1</sup>

Within this broad framework, there are a number of sub-strategies that are commonly classified as private credit; for simplicity, we group them into four categories here:

- 1. Direct Lending**—The largest segment of the private credit industry, these are loans provided directly to companies to support various business purposes; in many cases they support the purchase of a business by a private equity firm. They are considered non-investment grade and their repayment is supported by company cash flows. Direct loans may be classified as senior debt, which sits at the top of a company's capital structure and has first claims to cash flow and assets in the event of a reorganization or bankruptcy, mezzanine (a.k.a. "junior") debt that is subordinate to senior debt but higher than equity in the capital structure, or unitranche, a combination of senior and junior debt.
- 2. Alternative Credit**—This category may include Asset-Based Lending (loans secured by specific assets such as inventory, accounts receivable, equipment, or intellectual property), Leasing (leases offered on owned assets such as aircraft, ships, or equipment), or Specialty Finance (the provision of small business loans or consumer loans - e.g. automobile loans, student loans, credit card loans).
- 3. Opportunistic/Special Situations**—This represents capital provided to companies seeking a tailored solution to address a complex, and often critical, funding need. Some examples include strategic growth capital, funding a cash shortfall, or injecting so-called "rescue financing" to ward off bankruptcy. Capital provided could be in the form of senior or junior debt or preferred equity. (A close cousin is distressed credit, which generally entails investing in non-performing public debt<sup>2</sup> with the intention of leading the company through an in- or out-of-court restructuring process.)

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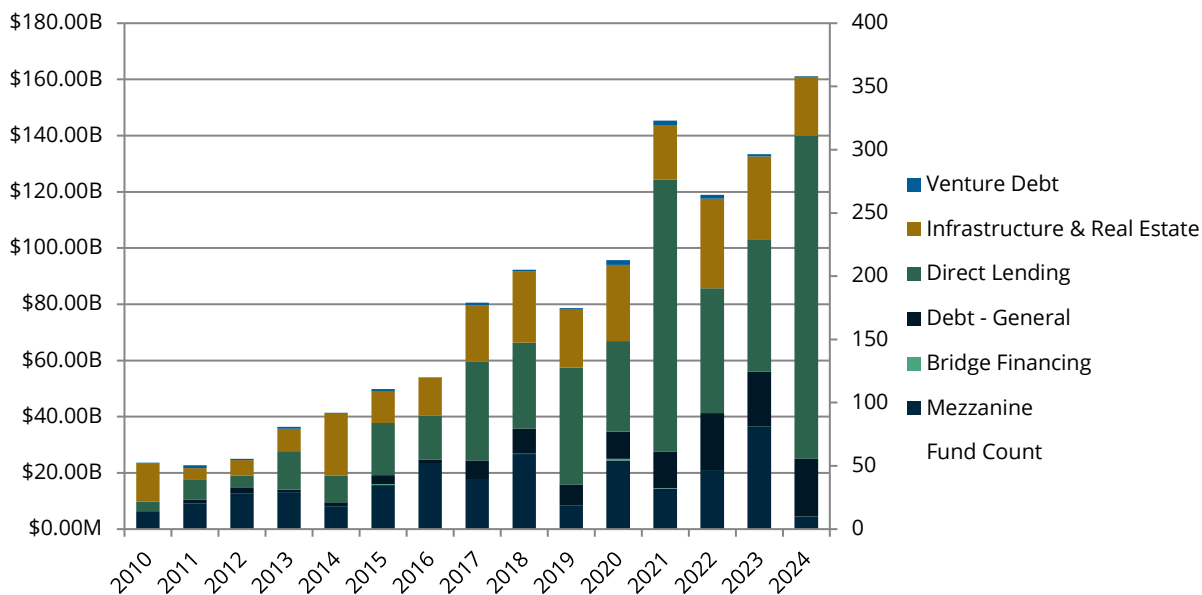
<sup>1</sup> Broadly speaking, firms generating EBITDA (earnings before taxes, interest, depreciation, and amortization) of \$25-100 million

<sup>2</sup> Debt on which scheduled payments of interest or principal have not been made

4. **Other**—Other types of lending activity that are often characterized as private credit include commercial real estate lending, infrastructure lending, and venture lending (i.e., lending money to companies backed by venture capital funding).

## Private Credit Market Development

The private credit market has grown substantially over the last 15+ years, with direct lending leading the way, as reflected in the chart below depicting the capital raised across various market segments since 2010:

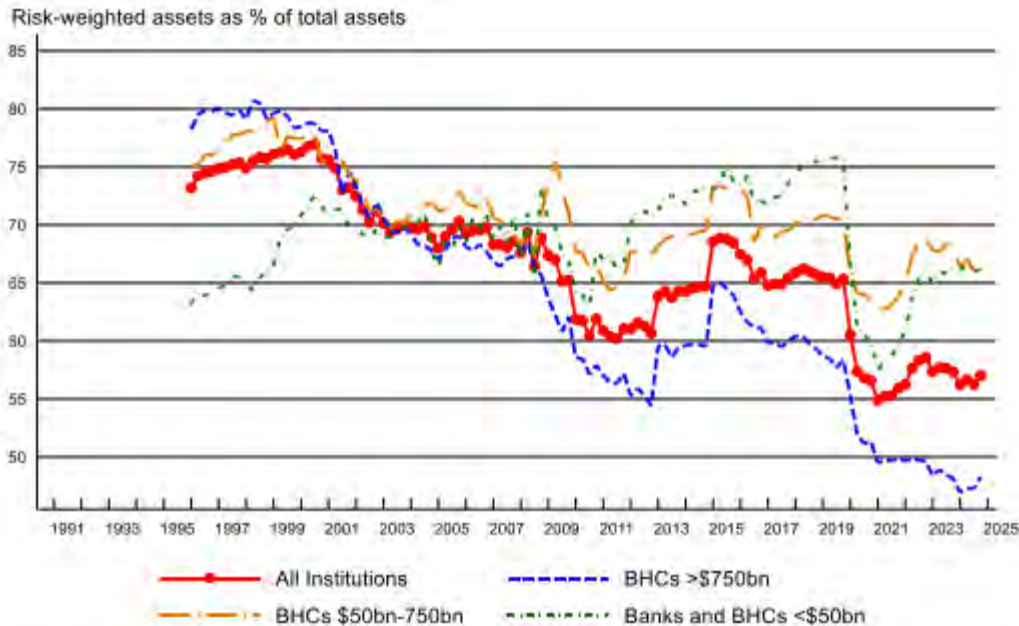


Source: PitchBook Data, Inc.

A key factor driving the growth in direct lending activity has been the continued development of the private equity industry, with direct lending firms providing debt financing to support corporate buyouts engineered by private equity managers. Augmenting this growth has been direct lenders capturing market share from traditional sources of buyout financing, such as publicly issued high-yield bonds and syndicated bank loans, as private equity owners have grown to value the ease, certainty, and speed of execution offered by direct lending versus public financing sources.

Also spurring private credit market growth, private credit providers are stepping in to fill the financing void created as banking institutions, which have increasingly pulled back from riskier lending activities in response to tightening regulation and credit standards, as depicted below:

## Risk-Weighted Assets Ratio



Source: Federal Reserve Bank of New York, Research and Statistics Group; BHC = bank holding companies

Traditionally, institutional and high net worth investors accessed private credit via investments in closed-end investment funds structured as limited partnerships, where a fund manager raises a fixed amount of capital that is drawn from investors (limited partners) and deployed into investments over time. Under this structure, limited partners' capital is "locked up" until the end of the fund's life, with distributions received only intermittently as interest and principal payments are made.

In recent years, private credit fund managers have increasingly raised so-called "open-end" funds to which investors can commit capital at any time, that have no defined termination date, and that offer a periodic redemption option. Retail investors, on the other hand, have traditionally accessed the private credit market via business development companies (BDCs) offered by some, but not all, private credit managers. BDCs issue a fixed amount of equity shares that are publicly traded, the capital from which is invested in private credit via application of the same investment strategy as that applied to complementary closed-end and open-end funds.<sup>3</sup>

## Appeal to Investors

From the standpoint of investment allocators, private credit offers a number of features:

- **Access to greater market opportunities**—As noted above, there is a wide range of private credit strategies offering investors access to a vast landscape of market opportunities beyond those available through public market investments, thus offering return and diversification potential.

<sup>3</sup> Publicly traded BDC prices may differ from the net asset value (NAV) of the underlying portfolio at any given time

- **Yield premium**—Largely stemming from the fact that they're usually held to maturity and not traded in an active secondary market, private credit instruments generally offer a higher yield than comparable-quality public market instruments.
- **Favorable performance characteristics**—Private credit investments historically have produced a return premium over publicly traded debt while exhibiting a lesser degree of volatility. Sources of this additional return include the yield premium on individual loans cited above, a better loss ratio, and, in some cases, the use of leverage—that is, borrowing additional capital that can be invested alongside that raised from investors, which can enhance overall fund returns.

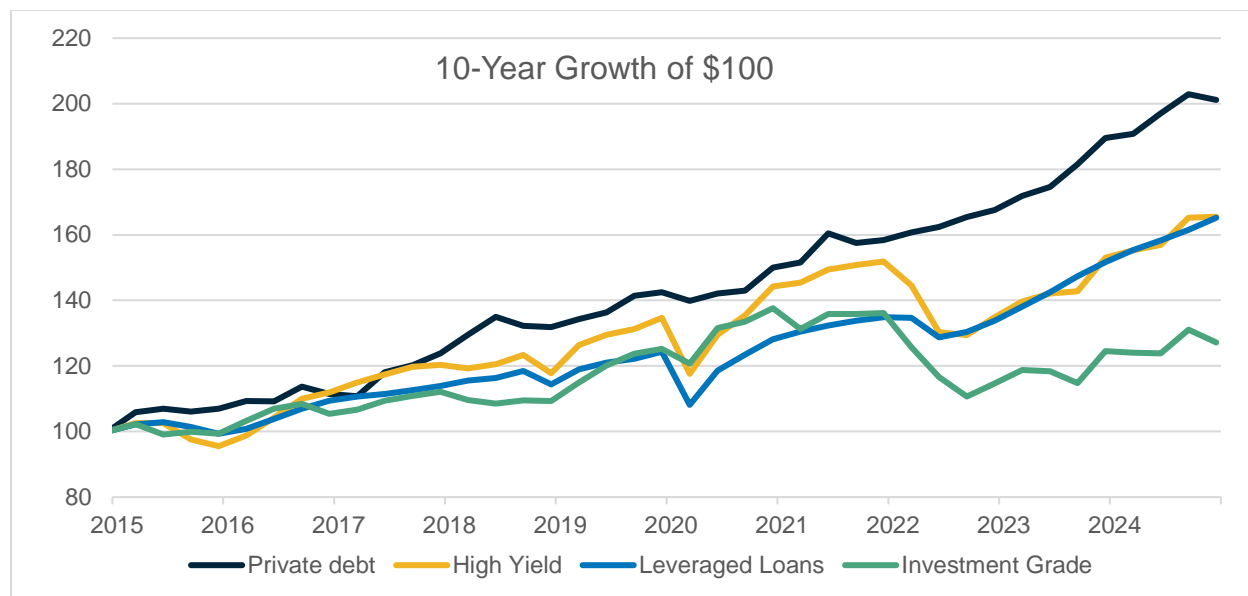
## Cautions for Investors

Of course, private credit is not a risk-free proposition, and there are a number of issues investors need to consider when allocating to the asset class:

- **Illiquidity**—As noted above, most private loans are held to maturity versus being actively traded on a public market. Additionally, the vehicle structure through which many investors access private credit—privately-raised closed-end funds—do not offer ongoing liquidity to fund investors; rather, capital is returned only upon the payment of interest and principal on loans over time.
- **Low credit quality**—Private credit investments are generally considered non-investment-grade given the smaller size and often higher credit profiles of most borrowers; further, opportunistic or distressed investments entail additional risk given the shakier status of the borrowers involved.
- **Estimated valuations**—Not being actively traded on public markets, private credit investments don't exhibit public market prices that investors can reference as an indicator of the performance of an investment; rather, private credit "prices" are based on estimated valuations determined by the private credit manager and/or outside third parties.
- **Use of leverage**—As noted above, applying leverage to fund investments can boost returns, but at the same time, can introduce additional risks related to the reliability and cost of such capital.

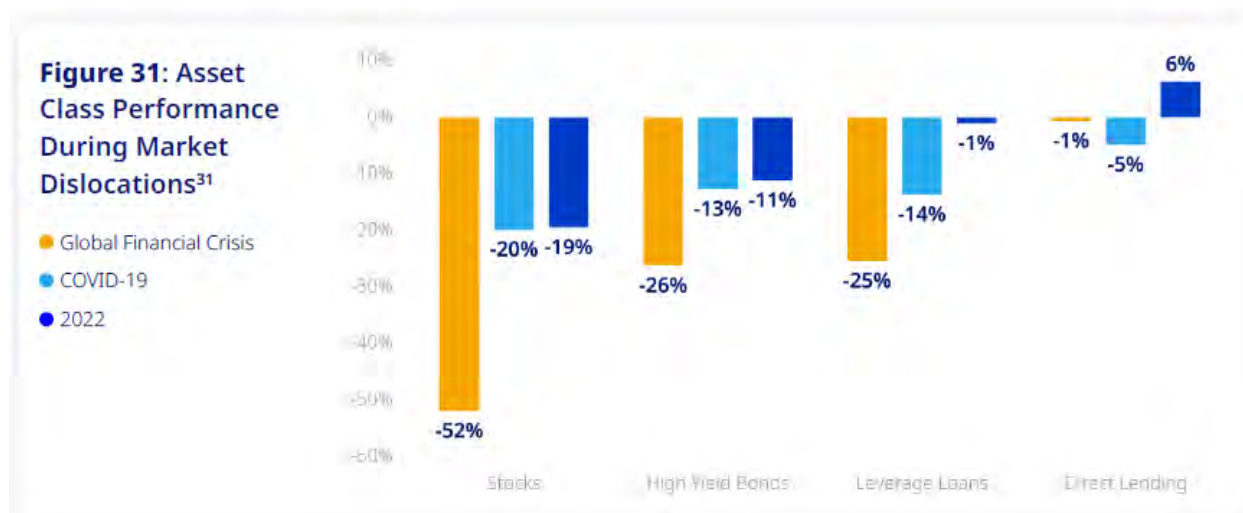
## Private Credit Performance Record

At a broad level, private credit has performed favorably compared to publicly traded debt alternatives over the past decade. As indicated in the chart below, a broad private credit index has outperformed both investment-grade and sub-investment-grade public debt indices:



Represents the growth of a \$100 investment in representative indices beginning 12/31/2014. Indices include PitchBook Private Debt Index, Bloomberg Corp. High Yield, Morningstar LSTA US Leveraged Loan, Bloomberg US Corporate Bond.

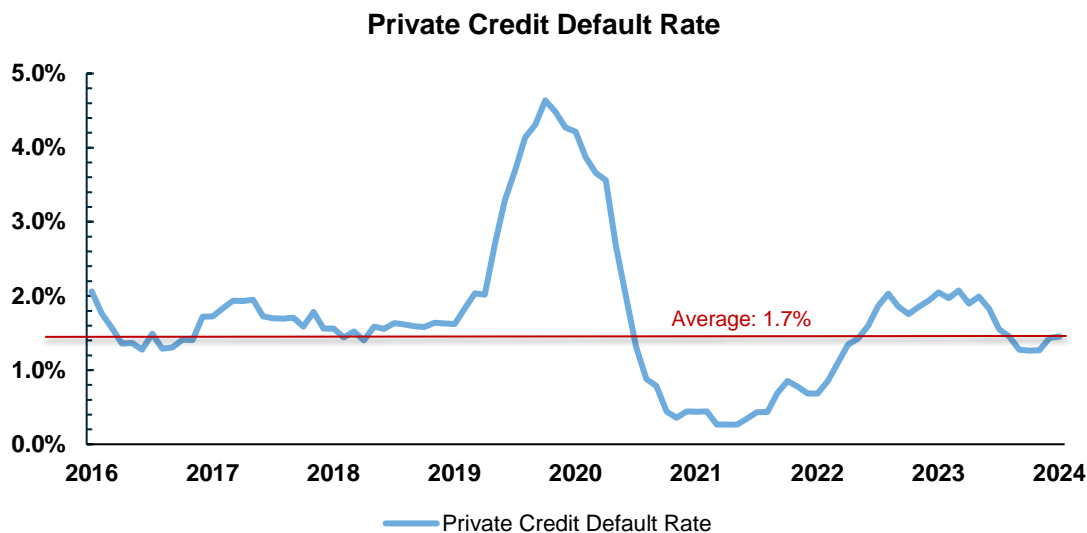
Further, a feature of private credit is that returns have historically been much less volatile than those of public debt instruments. In particular, private credit has held its value much better during periods of broad market dislocations, as depicted in the chart below showing the performance of a direct lending index versus competing asset classes during periods of market dislocations:



Source: Antares Capital Management. Data sources are Bloomberg, Credit Suisse Leveraged Loan Index, Cliffwater Direct Lending Index.

It is important to note, however, that a key reason for this is lesser volatility is that private loans are not “marked-to-market” on a daily basis like publicly traded securities, as noted above; rather, their on-going value is estimated periodically (often quarterly) based on factors like public market interest rates and credit spreads, along with the borrower’s underlying credit fundamentals. Their smoother performance pattern doesn’t mean that private credit loans are less risky on a fundamental basis than comparable leveraged loans or high-yield bonds, it just reflects the lack of daily public pricing.

Of course, the true test of riskiness for any loan is whether it’s repaid on time and in full, and in this regard, private credit has stacked up well. As depicted in the chart below, the default rate for private credit has averaged less than 2% since 2016, which compares favorably with average default rates for public leveraged loans and high-yield bonds over the same period of 3.6% and 4.4%<sup>4</sup>, respectively:



Source: PitchBook Data, Inc.

One reason for this favorable default experience is that private loans to small- and mid-market companies generally include stronger covenant packages compared to publicly issued debt of larger enterprises, thereby providing earlier “warning signs” of potential trouble at borrowers and enabling faster deployment of corrective actions. Further, in such situations, it is easier for a small cohort of private lenders to coordinate loan modification measures than a large and widely dispersed group of public investors. To be sure, the U.S. economy has been relatively durable throughout the period referenced above, and with the exception of Covid’s brief impact on the economy and financial markets, most private credit managers haven’t endured a prolonged economic downturn. As the saying goes, the proof will be in the pudding should such an environment develop.

<sup>4</sup> Moody’s Ratings



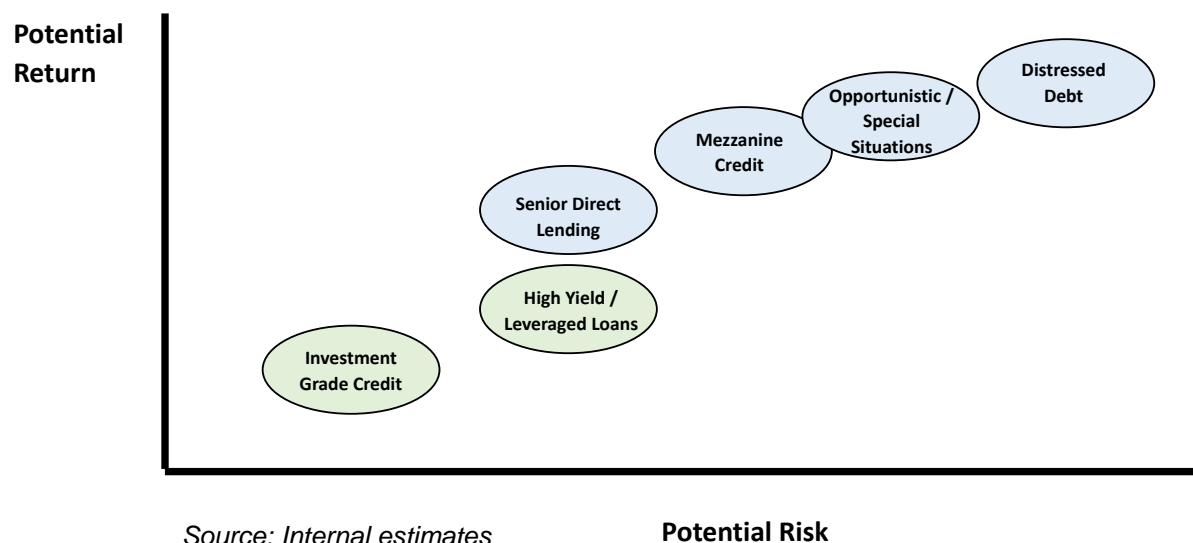
## Performance Characteristics of Private Credit Sub-Strategies

Notably, there are unique performance characteristics across different types of private credit sub-strategies. Standard direct lending returns are largely a function of interest rates charged on the loans, augmented by various fees or penalties that may be applied, such as an original issue discount<sup>5</sup> or a prepayment penalty. For senior direct loans, the interest rate is typically floating, comprised of a “base rate” based on a market interest rate (e.g., SOFR<sup>6</sup>) plus a yield spread over the base rate. As such, investors receive higher yields in a rising interest rate environment when the base rate increases; conversely, yields will compress in a falling rate environment.

Mezzanine loans, by contrast, often have fixed interest rates that exceed those on the same company’s senior debt, and frequently include equity participation in the company (e.g., warrants) to compensate for their greater risk profile given their lower placement in the capital stack.

A differentiating feature of alternative credit investments, such as asset-based loans, is a relatively shorter duration given their self-amortizing nature as periodic loan repayments include both principal and interest. Further out on the risk spectrum, opportunistic credit, like mezzanine debt, will generally feature higher yields to compensate for higher credit risk, and may also offer capital appreciation owing to accompanying equity commitments. Distressed debt, meanwhile, may generate a sizable portion of returns from capital appreciation as deeply discounted debt positions are sold at higher prices or converted to equity as part of a corporate reorganization.

In general, the different risk and return expectations for various private credit sub-strategies, along with common publicly traded debt investments, can be considered as follows:



## Allocation Considerations

Opinions vary on whether private credit is more appropriately categorized as an “alternative” or a fixed income allocation within a broad investment portfolio. In reality, private credit has elements of both: It fits the description of an

<sup>5</sup> A difference between the loan proceeds granted by the lender and the loan’s face value

<sup>6</sup> Secured Overnight Financing Rate, a broad measure of the cost of borrowing cash overnight

alternative investment given that it falls outside of the bounds of “traditional” publicly traded credit investments; at the same time, private credit, at a basic level, involves the issuance of credit, and therefore can reasonably be considered a complementary piece of a fixed income portfolio.

In this vein, private credit can most closely be compared to traditional high-yield or leveraged loan allocations, given the non-investment grade status of the underlying loans for each. As such, investors may consider allocating to private credit in the same proportion as they would to either of those publicly traded strategies. If historical return patterns persist, investors can reasonably expect higher returns over the long term from doing so; importantly, however, they must also be willing and able to bear private credit’s unique risks, particularly the illiquid nature of the underlying loans and fund vehicles through which investments are made.

At a more granular level, investors also need to consider the range of credit risk endemic to different private credit sub-strategies. The safest approach would focus on senior direct lending, in accordance with the risk-return chart depicted above. Beyond that, complementing such an allocation with other sub-strategies that have different return profiles would be expected to produce higher and more diversified returns, provided an investor is willing to accept the greater credit risk of the other sub-strategies. Additional considerations include whether to invest via a traditional closed-end or an open-end fund structure, and whether to invest in an unlevered or levered fund.

From a due diligence perspective, investors allocating to a private credit fund need to consider the same traditional factors reviewed in evaluating any fund—e.g., the experience and personnel stability of the manager, the robustness of the investment process, the manager’s performance track record, etc. Specific to private credit, however, two issues are worth particular attention: 1) the fund manager’s access to “deal flow” in terms of opportunities to lend capital; and 2) a stringent credit underwriting process and a track record of minimal credit losses—after all, the most important elements for success when lending money is getting your money back!

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