GCM GROSVENOR

Widening the Lens of Private Credit Through Co-Investing

March 2023

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Select risks include: *market risk, macroeconomic risk, liquidity risk, interest rate risk, and operational risk*

INTRODUCTION

We recently wrote about the attractiveness of private credit co-investing and highlighted some of the elements to do it successfully. Today, we continue to view co-investing in private credit as a "silver bullet" of sorts, as it allows investors to both capitalize on broad trends in the private credit market while also providing access to attractive investment opportunities that can create real value for portfolios in 2023.

Here we spotlight three market trends that are currently creating opportunities in private credit and examine certain execution challenges that have precluded many investors from implementing credit co-investments. We also discuss why we believe GCM Grosvenor is well-suited to mitigate these challenges and can deliver the benefits of private credit co-investing to our clients, in ways that suit them best.

PRIVATE CREDIT MARKET TRENDS

We have identified three market trends positively impacting private credit today. Our enthusiasm for private credit co-investing stems from our belief that it sits at the center of these trends:

1. Dramatic improvement in relative value in the past year
2. Largely untapped opportunity to realize diversification benefits
3. Increasingly dynamic nature of the opportunity set

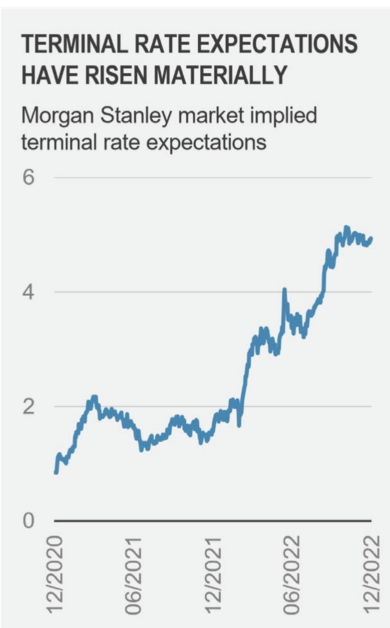
TREND 1: IMPROVING RELATIVE VALUE

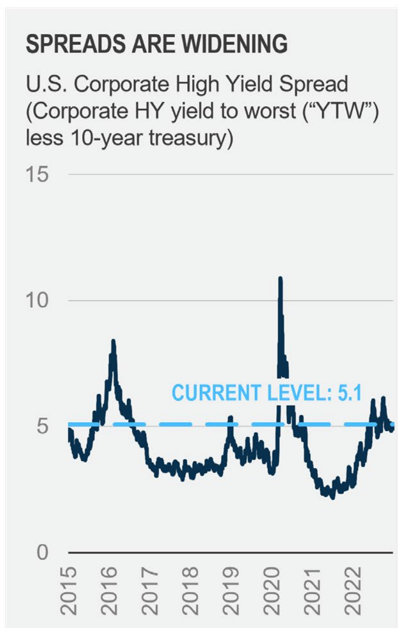
In private credit, there has been a meaningful shift in terms of expected return, and we are seeing some of the highest absolute returns in some time. As illustrated below, base rates have increased by 400 bps in the past year – a historic movement in both scale and speed. Meanwhile, spreads are widening at or above their historical averages, depending on the sub-sector, with the potential for further widening if economic conditions weaken.

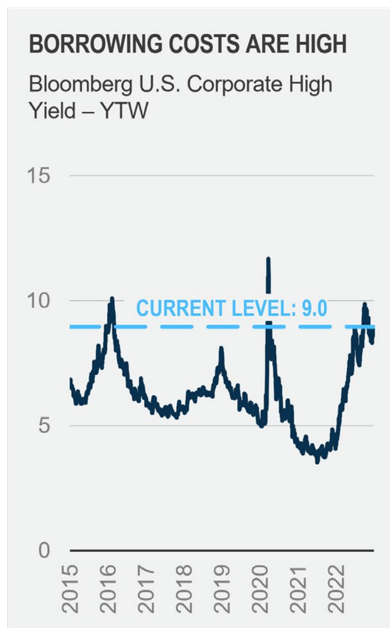
The combination of rising base rates and widening spreads has led to significantly higher borrowing costs. Thus, we are starting to see stress in levered capital structures and in their ability to remain cash flowing, which can potentially lead to stressed/distressed opportunities as well.

The result for investors: 500-800 bps or more of incremental return potential across private credit opportunities compared to just a year ago. We are now seeing an attractive beta opportunity in private credit.

It follows that asset allocation discussions, long dominated by equity opportunities, are starting to shift toward private credit. Absolute returns in private credit, which range from 10%-20% per annum or more across sub-strategies, along with the contractual yield and seniority in the capital structure of these assets, are making it easier for investors to find a place for private credit in their portfolios.







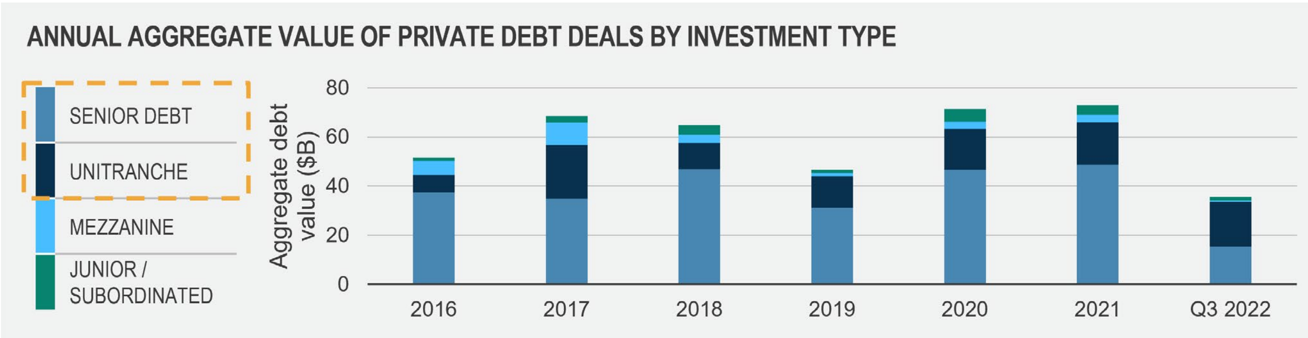
Data source: Bloomberg Finance L.P. Data as of December 31, 2022.

TREND 2: OPPORTUNITY TO REALIZE BENEFITS OF DIVERSIFICATION

Diversification can be one of the easiest and most powerful ways to enhance returns while maintaining strong downside risk mitigation – in fact, diversification is often called the only "free lunch" in investing.[1] But despite that, diversification has been slow to take hold in private credit.

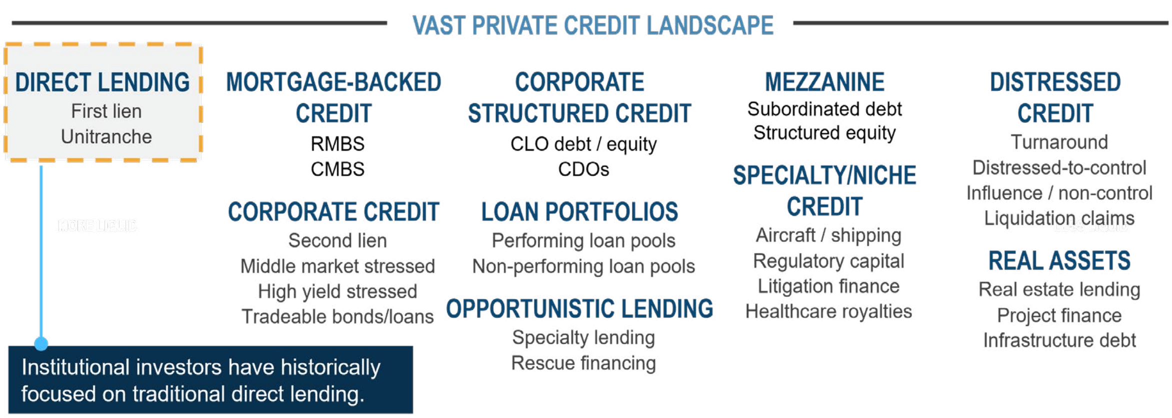
1 Risk management, diversification, and due diligence processes seek to mitigate, but cannot eliminate risk, nor do they imply low risk.

As illustrated below, most allocations in private credit recently have gone to traditional direct lending, and almost exclusively to the most senior part of capital structure: senior debt and first lien, or unitranche, deals. Those allocations allowed investors to diversify away from traditional investment grade and high yield exposures in seeking to earn excess return, at the cost of liquidity.



Data source: Preqin Pro. Data as of September 30, 2022.

While this approach made sense, we still feel it is a half-measure in that it largely did not account for broader private credit opportunities in institutional portfolios. The private credit sector is vast and, importantly, sub-strategies within it are not perfectly correlated with one another.



Thus, as an investor widens their exposures, there are substantial opportunities for diversification benefits in private credit. As illustrated below, historical correlations between different sectors are low, potentially providing lower volatility and correlation compared to a portfolio focused on direct lending.

				Correlation of Returns			
Benchmark Proxy	**Benchmark Source**	**Weight**	**Standard Deviation**	**Direct Lending**	**Mezzanine**	**Credit Special Situations**	**Preferred**
Direct Lending	Pitchbook	50%	7.9%	1.00	0.21	0.26	0.32
Mezzanine	Pitchbook	20%	14.5%	0.21	1.00	0.14	(0.12)
Credit Special Situations	Pitchbook	20%	11.3%	0.26	0.14	1.00	0.23
Preferred	S&P	10%	9.3%	0.32	(0.12)	0.23	1.00
Total			**6.6%**				

Source: PitchBook Data, Inc. benchmarks, quarterly rolling IRRs from 2013 Q1 to 2022 Q2.
S&P preferred stock index from 2013 to 2022.
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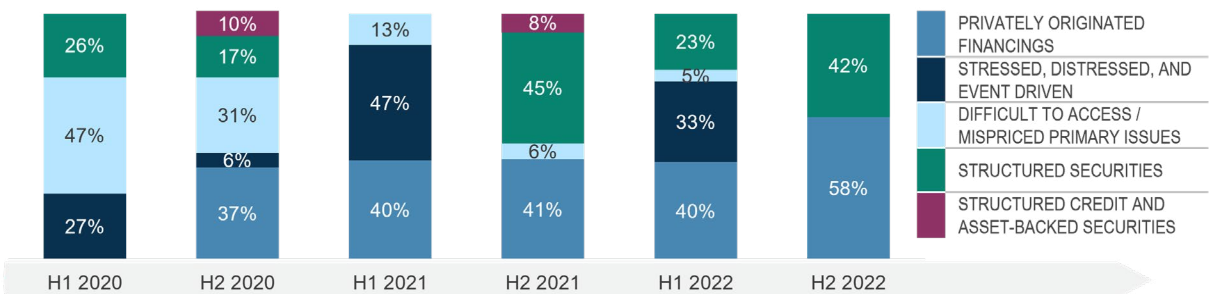
TREND 3: DYNAMIC OPPORTUNITY SET

The private credit opportunity set is fast-moving and difficult to predict over the long-term. This is due to a confluence of factors, but rate volatility and economic uncertainty are both key drivers. These and other drivers can combine to create a constantly shifting landscape of opportunities across sub-strategies.

In the chart below, we show our private credit co-investing activities, which fluctuated greatly quarter-to-quarter across sub-strategies in the past 2.5 years. Given the current macro environment, we believe this trend will persist, and one could argue that the market could become even more dynamic, particularly if economic stress were to continue.

GCM GROSVENOR STRATEGIC CAPITAL INVESTED



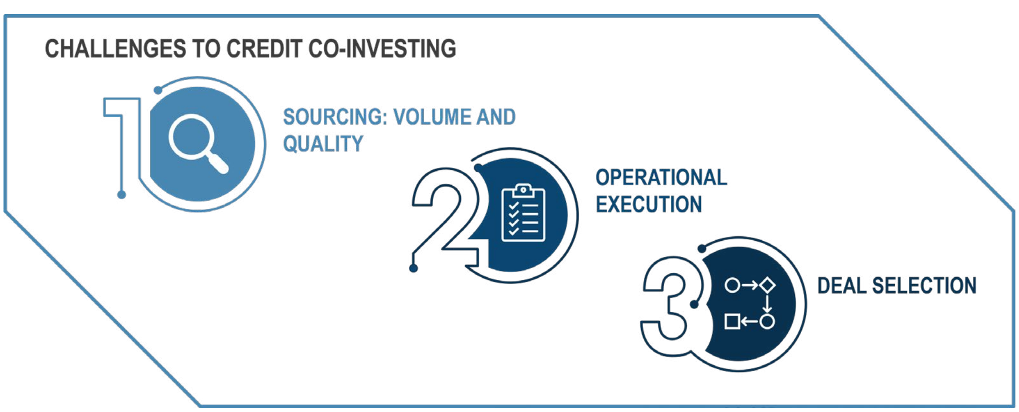
As of December 31, 2022 Graph only depicts credit investments in the Strategic Credit Strategy; non-credit transactions are not included.

CHALLENGES FACING CREDIT CO-INVESTING

In 2023, we believe private credit investors can achieve incremental return by capitalizing on increasing relative value, diversifying their private credit program across sub-strategies, and taking advantage of a dynamic opportunity set.

So, where's the catch?

Private credit co-investing is difficult to implement – we believe it is much more difficult than in private equity or other asset classes. Thus, there are several challenges facing investors who wish to implement a program. Here, we highlight three.



Challenge 1: Sourcing
While most investors wish to see a high volume of deals in their pipeline, it can be difficult to adequately cover the vast universe of private credit strategies and sub-strategies. As a result, blind spots may occur when assessing the opportunity set.

Of course, high quality deal flow is also critical. Investors must have the expertise to successfully identify the right opportunities and avoid adverse selection at the top of their deal-flow funnels. Failure to do so can lead to a "garbage-in garbage-out" effect if not effectively managed.

Challenge 2: Operational execution
Investors in private equity co-investments often have the luxury of time for diligence and execution and frequently have access to deals that are pre-packaged in SPVs, and thus easier to access. Credit co-investing, on the other hand, can be quite burdensome operationally.

First, investors need to be familiar with many private credit asset types, including loans, bonds, structured securities, preferred securities, convertibles, and many more. Second, private credit has short timelines and there are no pre-packaged SPVs – meaning no ease of access for investors. Third, there are many unique legal, tax, and structuring components to the deals, which can easily extend beyond an investor's area of expertise.

Challenge 3: Deal selection
In private equity co-investing, most strategies are predicated on sizing-up existing positions and achieving structural alpha by blending-down economics. However, in private credit co-investing, while enhanced economics are certainly present, the primary motivation is seeking to create excess return and diversification in a portfolio.

Thus, it can be challenging for an investor to properly identify and select the most attractive deals from a broad opportunity set and assemble them into a diversified portfolio. Doing so requires a sound investment process and the ability to underwrite deals and do "real" credit work. It comes down to the investor synthesizing all the input and making an independent investment decision.

HOW WE ARE ADDRESSING THE CHALLENGES

At GCM Grosvenor, we have been addressing the challenges and maximizing opportunities in private credit co-investing since the inception of our Strategic Investments Group eight years ago. Thus, we believe we can be strong partners for clients seeking the benefits this strategy offers.

We view the challenge of deal sourcing – in both volume and quality – as a competitive advantage because of our **global investment platform**. We have $74 billion deployed across more than 650 GP relationships, which produces high-volume and, importantly, high-quality deal flow. We see curated deal flow that goes beyond the marginal deals in the marketplace. Instead, we have curated relationships with managers selected by GCM Grosvenor professionals who are experts in their respective strategies.

All told, our team sees over 1,000 opportunities annually, and more than half of those are in private credit.

We also view **operational execution** as a competitive advantage. We addressed this challenge by building our own internal execution capability and fully removing the operational burden of co-investing from the GP. Thus, we are positioned to efficiently transact in any type of investment sourced by our team.

Today, we have a deep bench of operational resources. Our team includes tax and legal structuring professionals and middle- and back-office staff, we own our prime brokerage relationships, and have ISDAs in place with all counterparties.[1] In addition, our team members have trading skills across various product types.

The outcome: because of our resources and approach to execution, many General Partners view us as a good partner and easy to work with, which in turn generates more deal flow into the top of our funnel and creates a sort of virtuous cycle.

Finally, on **deal selection**, we have developed and continue to refine our investment process in seeking to deliver a high hit rate and achieve the desired returns. It begins with our experienced team, which is positioned to perform independent underwriting and ultimately make investment decisions. The team was hired from buy-side credit firms, hedge funds, private equity firms, and investment banks and have spent their whole careers doing direct deals.

PARTNERING WITH CLIENTS

By addressing the challenges in private credit co-investing, we believe we can provide clients with the benefits of enhanced returns by taking advantage of diversification opportunities and the dynamic opportunity set. We continue to form valuable partnerships with investors who are looking to grow and/or enhance their private credit exposure.

Today, our clients include a wide range of organization types with varying resources and objectives. Below is a snapshot of three ways we are working with clients to integrate private credit co-investing into their investment programs.

SINGLE POINT OF ENTRY	CO-INVESTMENT SOLUTION	STRATEGIC PARTNERSHIP
✓ Investors in early stages or new to private credit exposure in portfolio	✓ Clients with existing credit primaries seeking to build co-investments	✓ Investors targeting ways to drive specific deal flow in credit markets
✓ Turnkey solution to a diversified portfolio	✓ Efficient access to broad range of credit deal flow	✓ Enhance existing primary and co-investing activity
✓ Unique access without additional human capital and operational expense	✓ Operational and executional leverage	✓ Leverage collective resources and optimize execution

Increasing client involvement →

For illustrative purposes only.

Learn more about the GCM Grosvenor Strategic Investments Group.

1 GCM Grosvenor does not provide legal or tax advice. You should seek advice based on your particular circumstances from your independent tax advisor and/or legal counsel.

Important Disclosures

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Certain of the assumptions have been made for modeling purposes and are unlikely to be realized. No representation or warranty is made as to the reasonableness of the assumptions made or that all assumptions made have been stated or fully considered. Management fees, transaction costs, and potential expenses may not be considered and would affect the Financial Analysis. **Actual results experienced by clients may vary significantly from the Financial Analysis shown. The Potential Outcomes Outlined In The Financial Analysis May Not Materialize.**

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GCM Grosvenor (Nasdaq: GCMG) is a global alternative asset management solutions provider with approximately $74 billion in assets under management across private equity, infrastructure, real estate, credit, and absolute return investment strategies. The firm has specialized in alternatives for more than 50 years and is dedicated to delivering value for clients by leveraging its cross-asset class and flexible investment platform. GCM Grosvenor's experienced team of approximately 530 professionals serves a global client base of institutional and high net worth investors.

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