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Second quarter 2023

Private credit & private equity: Decision drivers for today's markets

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The private capital industry has seen a surge in popularity among investors seeking stability in the face of public market volatility, recession fears, and banking sector turmoil. Private capital not only provides the potential for attractive income and returns but also serves as a less correlated portfolio diversifier, generally with lower mark-to-market volatility than the public markets. In today's economic climate, many investors are prioritizing scaled, conservative managers with proven track records and all-weather portfolios to help them meet their investment objectives. The confluence of higher interest rates and overall economic uncertainty can lead to attractive private capital investment opportunities; however, it is critical to align with experienced managers that remain vigilant, selective, and diversified.

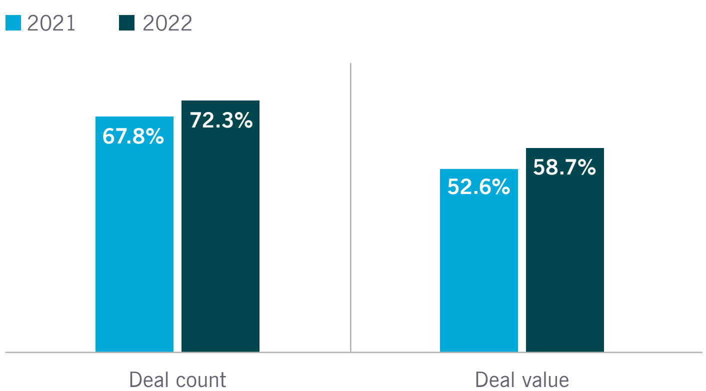
For a look behind the scenes in a dynamic market, Churchill's two investment teams – senior lending and private equity solutions & junior capital (PEJC) – share what is top of mind today from an underwriting perspective. Here are the primary three reasons we are both completing deals and turning down deals in this environment.

TOP THREE REASONS WE'RE COMPLETING DEALS TODAY

1. Already in our portfolio

In a volatile market, the best and healthiest companies often play offense and seek to grow through M&A. Private capital managers with large existing portfolios and flexible mandates are well positioned to benefit from this trend. Through Q1 2023, financing add-ons within Churchill's existing portfolio have seen a meaningful uptick, representing 60% of senior lending volume and accounting for 20% of the capital deployed by its equity co-investment strategy. We expect to see tailwinds for add-on activity to continue well into 2023 from 2022, where add-on transactions represented over 70% of all U.S. middle market private equity deal count[1].

Add-Ons of U.S. middle market private equity activity



1. Data source: Pitchbook 2022 Annual U.S. PE Middle Market Report

Not only do add-ons provide a diversified source of deal flow, they also offer an enormous information advantage. An existing investor has a front seat to historical performance, along with direct access to board-level conversations and decisions. With first-hand investor experience comes a better ability to understand business risks and make more informed decisions. As a manager of $46bn[2] of private capital and 450+ portfolio companies, Churchill continues to benefit from the advantages of add-on investments in today's market.

2. Top sponsor relationships

Investors must adjust to a new paradigm after 10+ years of strong market conditions. In today's environment, partnering with top-tier private equity firms is more important than ever. Those with strong investment teams, proven value creation strategies and differentiated networks of operating partners and potential executives have the ability to perform irrespective of broader economic conditions. Furthermore, working with a large number of top-tier sponsors can give investors a wide perspective on deal flow, driving increased selectivity. The ability to both identify and access private equity firms with which to partner is predicated upon years of relationship building, cemented by scale and a longstanding presence in the market.

3. Less cycle sensitive

Many investors have been positioning their portfolios in anticipation of a downturn for several years, seeking to back non-cyclical assets. Yet, what does it mean to be "non-cyclical" in today's world? The last five years have shown that performance during negative GDP growth is not the only factor to consider when evaluating the durability of businesses. Pandemics, inflation, and rising interest rates all have the potential to wreak havoc on profitability and growth. Investors should focus on partnering with companies that succeed in any macroeconomic environment. Churchill seeks to identify businesses whose products and services are a) non-discretionary, b) purchased on a recurring basis, and c) comprise a small percentage of customers' overall cost structure but command a high cost of failure. In our experience, companies that demonstrate a combination of these three factors are most likely to provide downside risk mitigation protection in a variety of market conditions.

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TOP 3 REASONS WE'RE TURNING DOWN DEALS TODAY

1. Lack of sustained free cash flow

While cash flow generation has always been a critical measure in evaluating new and existing investment opportunities, the recent (and rapid) rise in interest rates has led to a recalibration to more conservative leverage profiles.

Companies are now subject to meaningfully higher cash outflows as a result of higher interest burdens. An important and dynamic component in forecasting incorporates assumptions around both current and forward SOFR curves, and how changes in underlying rates will impact interest coverage cushions under various business scenarios. Like-for-like leverage levels have declined for companies to adequately cover their increased all-in borrowing costs.

Additionally, a company's quality of EBITDA is of vital importance. Peeling back EBITDA adjustments to validate if earnings are truly sustainable is crucial for equity co-investors to gaining conviction on exit EBITDA metrics. Similarly, the more sophisticated lenders are confirming that financeable EBITDA truly serves as a proxy for cash flow. Ultimately, earnings will play an even greater role than interest rates in influencing a company's ability to service debt. Lastly, we are scrutinizing companies with more aggressive capex plans which could hamper a company's ability to cover its fixed charges. We are seeking clarity on how quickly capex spend converts to revenue as well as a company's ability to shut off expenditures in a downside scenario.

2. Insufficient shareholder alignment

Greater equity alignment between private equity sponsors and management teams typically provides lenders and co-investors alike significant comfort that their sponsor partner will continue to support a portfolio company through business-specific or macroeconomic headwinds. We have even found that a greater equity contribution (from sponsors and management) at deal origination directly correlates to the amount of support provided in times of distress. Additionally, a cash equity investment provides a true market valuation and loan-to-value for a particular asset, as opposed to calculating an implied enterprise value. As we continue to evaluate downside scenarios, we believe that companies with sufficient levels of sponsor and management team alignment will have a higher ability to withstand potential headwinds. If we do not see sufficient alignment of shareholder interest, we take note and will pass on the opportunity.

3. Lack of ESG incorporation

While credit investors and co-investors alike have historically had less governance influence than their private equity counterparts, the influx of capital into the asset class has enabled the constituents in these strategies to effectuate positive change by screening out businesses that fall behind the curve from a responsible investing perspective. At its core, this means not only applying an Environmental, Social and Governance ("ESG") lens to high-risk business models, but also identifying (and advocating for) businesses that have an opportunity to make positive societal changes. Our ESG due diligence framework, which we developed in partnership with Nuveen, is an important tool that we use in filtering new opportunities, and we have used this to selectively decline opportunities with questionable corporate policies or with workplaces that lack diversity or inclusivity. We have typically found that those businesses on the front foot of the ESG spectrum, supplemented by new private equity partners with an eye to furthering innovation to encourage more sustainable practices, will be positioned best to navigate the ever-changing market landscape.

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RISK-RETURN CONSIDERATIONS ACROSS STRATEGIES

Our equity co-investment and senior lending investment teams share a similar investment approach and philosophy, rooted in a focus on downside protection and capital preservation. However, our private capital strategies have a range of risk-return objectives that may lead our teams to prioritize different underlying investment characteristics. Between co-invest and senior lending, differences arise in reliance on growth for positive investment outcomes. While a growing company provides a nice cushion for a senior lender, it does not change the return profile of a senior loan and growth expectations do not have a material impact on underwriting. On the other hand, growth is the lifeblood of an equity investment, and a prerequisite for capital deployment. Without clear and numerous paths to earnings growth, our co-invest team will not commit to an investment.

CONCLUSION

In today's world, volatility and uncertainty is around every corner. For those seeking partnership with private capital managers, it is more important than ever to choose wisely. Churchill's professionals have decades of experience investing nearly $50bn of capital across multiple strategies. Whether senior lending, junior capital, equity co-investment or secondary opportunities, we are highly focused on the topics that matter in our effort to deliver top-tier returns year-in and year-out.

For more information, please visit nuveen.com.

Endnotes

1 Pitchbook 2022 Annual U.S. PE Middle Market Report. 2 Reflects committed capital as of 01 Jan 2023. The amount of 'private capital invested' shown above includes private credit and private equity investments made, originated or committed to by Churchill Asset Management LLC and its affiliates, including TIAA, since 2011 (in respect of its Private Equity and Junior Capital platform) and since 2015 (in respect of its Senior Lending platform). Investments include committed investments that ultimately may not have been fully drawn or funded.

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