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Thriving in Challenging Times:

Leveraging Private Credit amidst higher interest rates and inflation, as well as exploring Economic Opportunity Zones

August 2023

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What is Private Debt?

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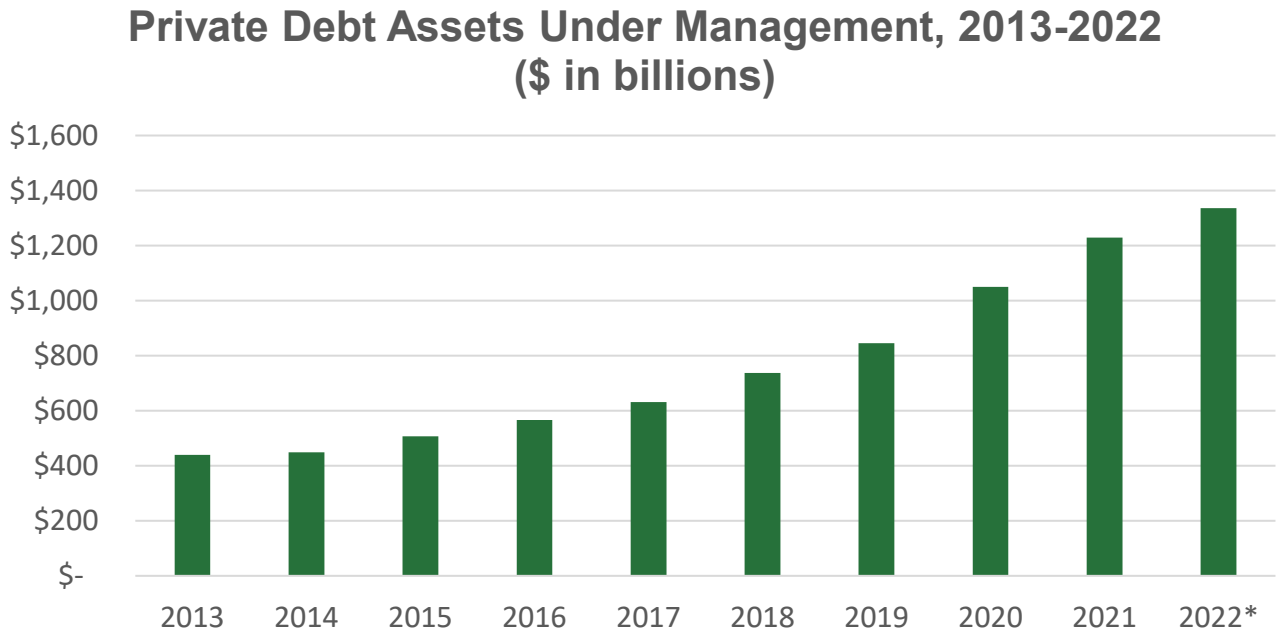
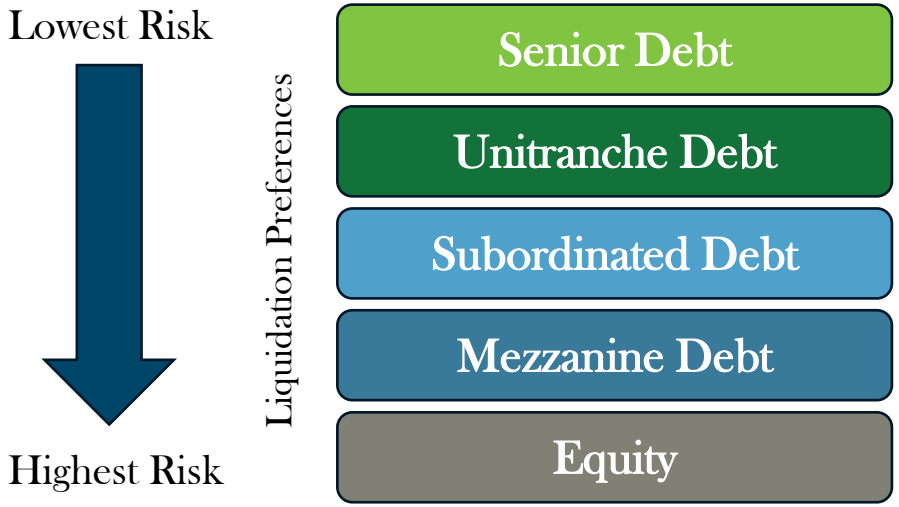
Private debt refers to debt financing that is provided by non-public entities, such as private companies, institutional investors, or private funds, to other entities, typically businesses.



Rise of Private Debt AUM: Filling the Gap in Riskier Lending since GFC

The increase in Assets Under Management (AUM) for private debt originated during the Global Financial Crisis in 2007-2008. Traditional lenders, such as banks, became hesitant to offer riskier loans, creating a gap that was filled by private or direct lenders.



* As of end-June 2022.
Assets under management represents the total value of dry powder and unrealized value. Real assets includes real estate, natural resources and infrastructure funds.
Source: *Preqin Pro*.

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Economic Challenges and Market Disruptions

Economic Uncertainties: Impact of Russia-Ukraine Conflict, Inflation Surge, and Federal Reserve's Measures

- Russia's invasion of Ukraine has caused economic uncertainties and disruptions in global markets.
- Post COVID-19 inflation
  - According to research from U.S. Bureau of Labor Statistics, the rise of inflation since 2020 was due to: “volatility of energy prices, backlogs of work orders for goods and service caused by supply chain issues due to COVID-19, and price changes in the auto-related industries.”
- The Federal Reserve's aggressive interest rate hike to combat inflation negatively impacted the stock market, increasing borrowing costs for companies and reducing consumer spending.
- Raising interest rates also lead to a negative effect on bonds, causing their prices to decline and yields to increase.
- In 2022 the 60/40 portfolio had the worst performance (18% total loss) since 1937.

[1]Source: Duberstein, Billy. “2022 Was the Worst Year Since 1937 for This Investing Strategy: Here’s What History Says Happens Next.” *The Motley Fool*, 26 Jan. 2023.
[2]Source: “2022 Annual Global Private Debt Report.” *Pitchbook*, 15 Mar. 2023.
[3]Source: “Private Debt”, *Prequin*

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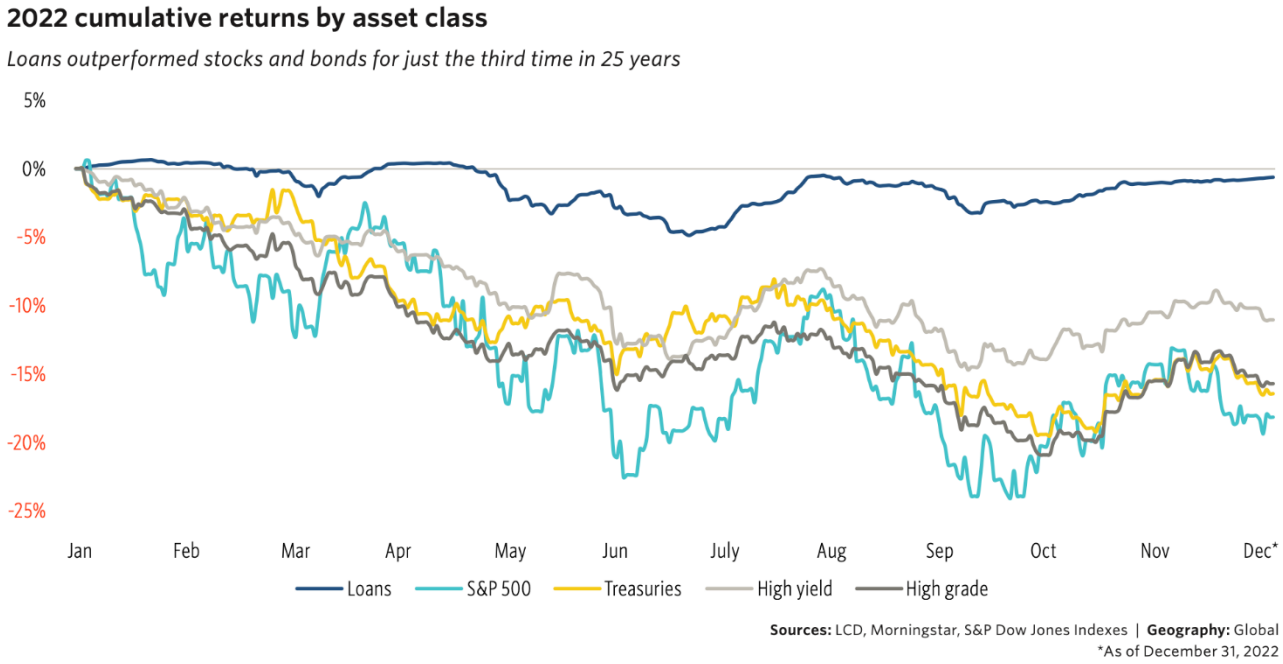
Private Debt Compared to Other Asset Classes

Recent Financial Turmoil: Private Debt as a Solid Investment in Times of Uncertainty

- Private debt has low correlation with public markets.
- Offers portfolio diversification.
- Investors can expect predictable and contractual returns based on the interest rate charged.
- This investment option carries lower risk than private equity, given that debt holds a higher position than equity in the capital structure.



Rise in Private Debt Investment

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What is the current market condition of Private Debt?

- In 2023, the U.S. experienced three out of the top four largest bank collapses ever, which included First Republic Bank, Silicon Valley Bank, and Signature Bank.
- The exodus of customers from regional banks may prompt regulators to implement even more stringent regulations.
- Many regional banks heavily invested in the commercial property market, which is currently facing significant credit risks due to the unfavorable outlook for both retail and office properties.
- The ongoing banking crisis is likely to result in regional banks facing stricter lending standards and a challenging capital-raising environment, creating additional opportunities for private debt investments.

RISE IN PRIVATE DEBT

3 of the Largest Bank Collapses in the U.S.

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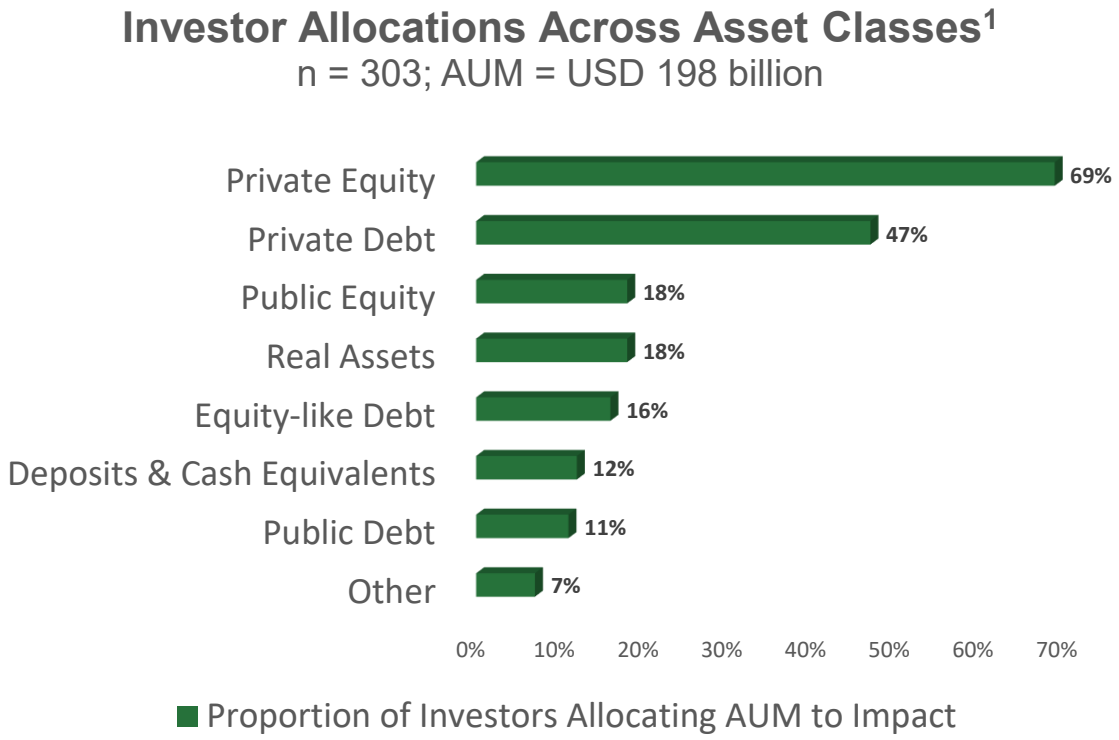
According to Preqin, private debt is forecast to have annual average returns of 8.4% from 2021 to 2027.

[1]Source: Keith Brakebill "Opportunity from crisis: How Private credit stands to benefit from recent tumult in the banking system" *Russell Investments*, 22 Mar. 2023.

Impact in Private Debt

- 47% of Private Debt investors invest with impact.



How to create Impact with Private Debt Investments?

- Sustainability-linked bonds have emerged as a way to link interest rates to the issuer's ability to achieve a pre-determined social or environmental objective that maps to the SDGs or other sustainability objectives[2].

[1]Source: *Global Impact Investing Network (GIIN)*, 2023 GIINsight: Impact Investing Allocations, Activity & Performance.
Note: Excludes five outlier organizations based on AUM. 'Other' asset classes include social impact bonds, pay-for-performance instruments and guarantees.
[2]Source: "How private credit investors can get a grip on impact." *New Private Markets*, 18 Nov. 2021.

Introduction, Tax Incentives and Impact

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What are Opportunity Zones?

According to the IRS, Opportunity Zones "are an economic development tool that allows people to invest in distressed areas in the United States. Their purpose is to spur economic growth and job creation in low-income communities while providing tax benefits to investors."

What tax incentives are offered in Opportunity Zones?

When you invest in Opportunity Zones, you can defer tax on eligible gains, which include both capital gains and qualified 1231 gains. The gains MUST be recognized for federal income tax purposes before January 1, 2027, and not from a transaction with a related person.

You can defer tax on eligible gains until you have an inclusion event event that reduces or terminates investment in a Qualified Opportunity Fund or by December 31, 2026, whichever is earlier.

[1]Source: IRS
[2]Source: "Unrealized Gains, Opportunity Zones and Small Businesses." *Smart Growth America*, Oct. 2020.

Impact on Small Businesses and Local Communities

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What is the impact in local communities when investing in small businesses located in Opportunity Zones?

Investing in small businesses within Qualified Opportunity Zones can play a pivotal role in bolstering local economies, stimulating job opportunities, and nurturing entrepreneurship in these specific census tracts. As a result of such investments, these communities have the potential to experience lasting prosperity and wealth creation.

[1]Source: IRS
[2]Source: "Unrealized Gains, Opportunity Zones and Small Businesses." *Smart Growth America*, Oct. 2020.

Challenges

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What are the challenges to create impact in Opportunity Zones?

1. Predominant investments in real estate

Most Opportunity Zone investments have favored real estate developments due to their alignment with tax incentives. However, it remains uncertain whether these investments fulfill the desired social impacts envisioned by the community and legislators. Equity investments, tangible asset requirements, and the ten-year investment timeline have largely driven funds and investments toward real estate.

2. Absence of debt investments

The tax incentive for Opportunity Zone investors does not permit them to invest in small businesses using debt, which is a major source of capital for their growth. Instead, the incentive favors longer-term equity investments with higher return demands, making it less compatible with low-growth small businesses.

[1]Source: "Unrealized Gains, Opportunity Zones and Small Businesses." *Smart Growth America*, Oct. 2020.

Thank you!

Monika Mantilla

monika@alturacap.com