Bulog Capital

Bulog Capital, LP, directly lends to private equity (PE) financial sponsors in the software-as-a-service technology industry. Kelvin Falsey, CFA, is a manager in Bulog's underwriting and origination group. He is currently underwriting a debt proposal to help a PE firm, Crane Capital, finance an add-on acquisition and is creating a preliminary term sheet to present to Bulog's investment committee for approval.

Crane wishes to subordinate an existing mezzanine loan at a holding company (HoldCo) subsidiary. The subsidiary's only asset will be its interest in the common equity of the operating company (OpCo), which will pledge assets as collateral to the lender.

Bulog's preliminary term sheet outlines a $200 million, 5-year unitranche loan facility with a proposed interest rate of the SOFR plus a quoted margin of 700 bp per annum, reset and paid quarterly. The 90-day SOFR is currently 5.38%. The term sheet further proposes a first lien pledge of all assets. Origination fees, call features, and various debt incurrence covenants are also included in the terms.

Another lender, ADLADS Capital, has submitted a competing term sheet with a more traditional first lien and second lien leveraged loan structure, with the following proposed terms summarized in Exhibit 1:

Exhibit 1 ADLADS Capital Summary Terms

Terms	First Lien Tranche	Second Lien Tranche
Size (par)	$150 million	$50 million
Interest rate	SOFR + 600 bp per annum	SOFR + 1,200 bp per annum
Tenor	4 years	7 years
Covenants	Maintenance covenants TBD	Incurrence covenants only

Assume for both proposals that the SOFR base rate remains unchanged for four quarters.

After several quarters, Crane completes a private offering of $50 million of preferred stock at the OpCo. A year later Crane is able to sell the portfolio company to another PE firm for $500 million. At the time of the sale, the company had $200 million in secured loans and the $10 million mezzanine loan as the only debt claims outstanding. The preferred stock has a $60 million liquidation preference and 5% transaction costs.

Question 1.1

Based only on annual interest expense, which financing proposal is *less* costly to the sponsor?

A. Bulog's proposal ✓

B. ADLADS's proposal

C. Bulog's and ADLADS's proposals are equally costly

Explanation:

Annual debt interest cost is important to an analyst comparing multiple financing offers. In this case, to approximate annual interest cost, the quoted margin is added to the SOFR base rate and applied to the proposed debts' face values.

ADLADS's terms propose two different loan tranches at different quoted interest margins. For comparison, ADLADS's annual interest cost is a weighted average calculated from the proportions of the first lien and second lien loans.

Calculation of annual interest costs (in USD)

	Bulog proposal	ADLADS proposal
Calculate annual simple interest cost	Interest cost = Principal × Rate × Time (years) = 200,000,000 × ((0.0538 + 0.0700) × 1) = 24,760,000	Interest cost = Principal × Rate × Time (years) = (150,000,000 × (0.0538 + 0.0600) × 1) + (50,000,000 × (0.0538 + 0.1200) × 1) = 25,760,000
Compare interest costs	24,760,000 < 25,760,000 Bulog < ADLADS	

The higher interest rate on the riskier second lien loan (SOFR + 1,200 bp per annum) from ADLADS's proposal makes the weighted average interest cost greater than in Bulog's proposal; Bulog's proposal is thus less costly for Crane **(Choices B and C)**. Had the annual interest costs been identical, the PE sponsor would rely more heavily on other terms such as fees, covenants, and tenor to select the better proposal.

Things to remember:
Debt interest cost should reflect the debt structure and loan-specific interest rates. Interest rates include the base rate plus the quoted margin and are applied to the par amount of each debt tranche with its specific interest rate.

Question 1.2

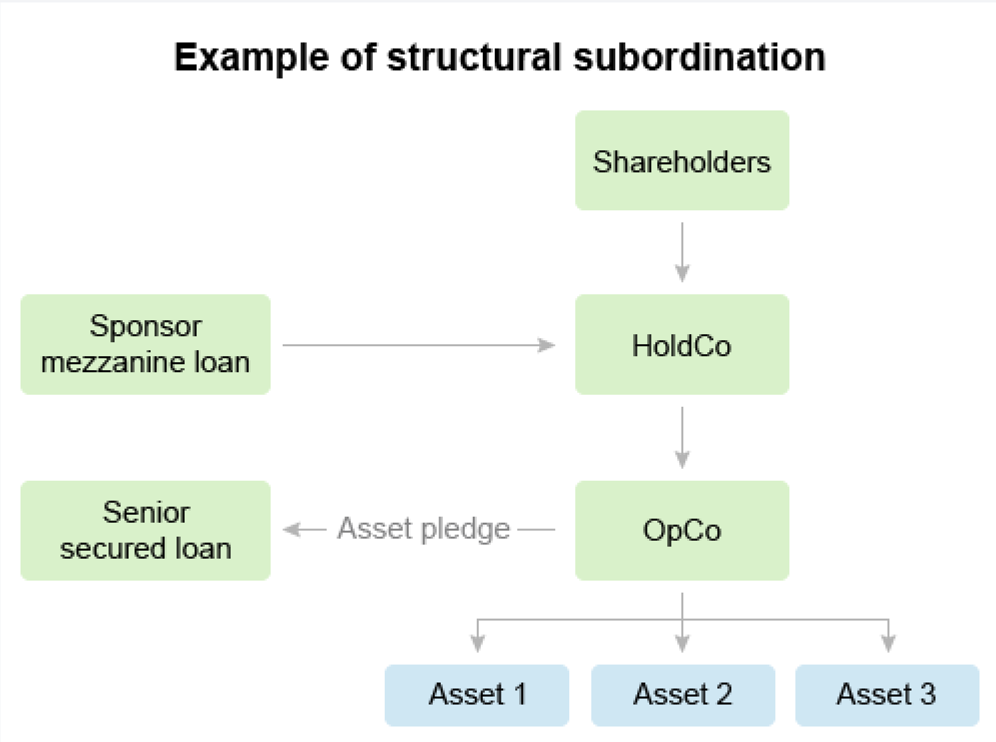
If Crane subordinates the mezzanine loan to other debt, which of the following *best describes* the form of subordination?

A. Lien priority

B. Structural ✓

C. Contractual

Explanation:



Structural subordination is the **hierarchical** arrangement of debt obligations within a company's capital structure. Certain **debt instruments** are **prioritized** over others in the event of sale, bankruptcy, or liquidation, based on the obligation's relative priority in **recovering value** from the collateral pledged against the loan. In this scenario, Crane wishes to structurally subordinate the mezzanine loan.

(Choice A) Lien priority is determined by legal contracts that state the priority of one creditor's claim on a security interest in the debtor's assets versus other creditor claims. In this scenario, ADLADS's terms would necessitate a prioritization of liens, as second lien lenders must be willing to accept a lower priority in repayment compared with the first lien lenders.

(Choice C) Contractual subordination is a legal agreement documented between creditors that alters the priority of debt repayment in the event of a borrower's default or bankruptcy. Unlike lien subordination, contractual subordination affects the priority of repayment among different classes of debt. ADLADS' terms do not propose any contractual subordination as all debt is senior secured.

Things to remember:
Structural subordination is the hierarchical arrangement of debt within a company's capital structure. Structural subordination defines a debt obligation's relative priority in recovering value from the underlying asset collateral.

Question 1.3

If Crane issues $50 million of OpCo preferred stock, which of the following *best describes* the mezzanine debt's claim on OpCo assets?

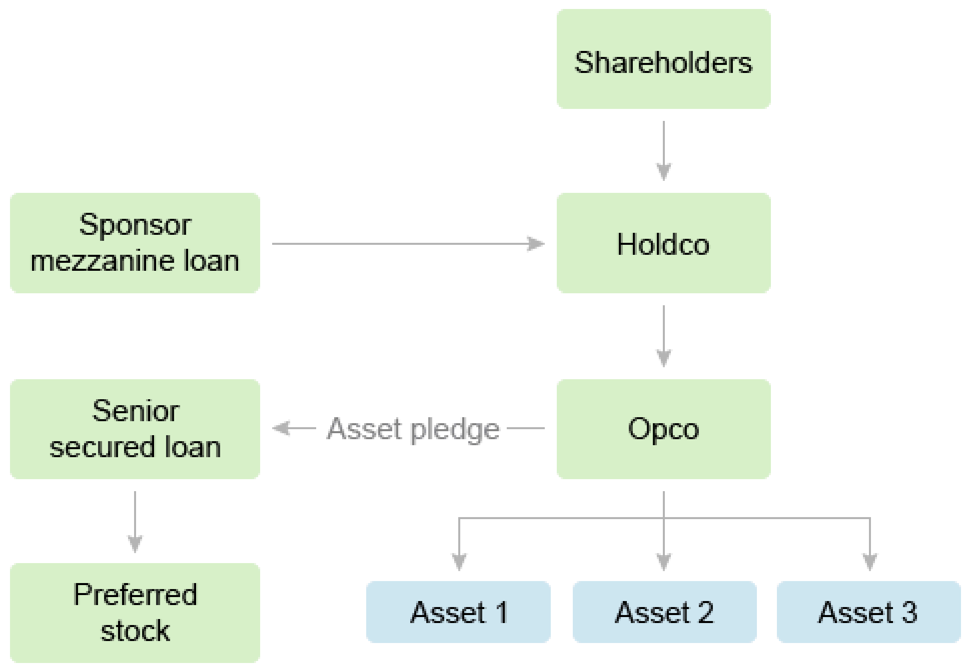
A. No claim

B. Second lien claim

C. Subordinated debt claim ✓

Explanation:

Investment structure following sponsor preferred stock issuance



An **operating company** is one that primarily engages in **day-to-day** business **operations** while typically borrowing to finance operations by **pledging** its **assets** as **collateral**. A **holding company** is a type of business entity that exists primarily to hold **controlling interests** in its **subsidiaries**. A common corporate structure is one where the holding company owns a controlling interest in the operating company.

The mezzanine loan at HoldCo has a structurally subordinated claim on OpCo assets, but only to the extent that these assets, which have been pledged to bank lenders, have any residual value after the secured lenders and preferred stockholders are repaid.

(Choice A) The mezzanine lenders do have a claim on OpCo assets, but it is only a common equity claim due to the absence of any liens or a security interest in the assets. The mezzanine loan has no direct claim on the assets at OpCo. Should there be no common equity value at OpCo, there would be no value attributable to HoldCo common equity.

(Choice B) The preferred stock and mezzanine loan have no second lien claim, or secured claim at all, at OpCo, as the senior secured loan is the only secured debt there. If the mezzanine loan had been contractually structured as OpCo second lien debt, it would be repaid to the extent that the collateral value exceeded the first lien claim, and before the unsecured $50 million preferred equity claim at OpCo.

Things to remember:
Structural subordination is the hierarchical arrangement of debt within a company's capital structure. HoldCo subordinated debt obligations receive only the residual value of OpCo assets to the extent the collateral value is sufficient to repay secured lenders and preferred stockholders.

Question 1.4

With the sale of the entire company, the value ($ millions) returned to shareholders is *closest* to:

A. 205 ✓

B. 230

C. 290

Explanation:

Company sale proceeds distribution ($ thousands)

Total sale proceeds		500,000	
Total fees / expenses	(25,000)		
Net sale proceeds		475,000	
Senior secured loans	(200,000)		Opco claims
Preferred stock	(60,000)		
Opco residual equity value to holdco		215,000	
Shareholder mezzanine loan	(10,000)		Structurally subordinated holdco claim
Holdco residual equity value to shareholders		205,000	

Fees and expenses are deducted from sale proceeds before any distributions are made. The first distribution is made to the secured lenders at OpCo. This claim has a lien on the assets being sold and must receive priority repayment. The remaining OpCo value repays the preferred stock liquidation value. Any residual OpCo common equity value would flow to HoldCo to repay the $10 million mezzanine loan, with the balance of HoldCo equity value going to shareholders.

(Choice B) $230 million fails to net out the 5% transaction costs, or $25 million, from the distributable value.

(Choice C) $290 million fails to net out the 5% transaction costs and fails to distribute the $60 million OpCo preferred stock liquidation value, thus overstating HoldCo equity value to the shareholders by $60 million.

Things to remember:
Debt repayment priority from the sale or bankruptcy liquidation of a company is largely dictated by the specific type of relative subordination or prioritization among the various debt claims.

WBCP Private Debt

Roy Garza, CFA, is a portfolio manager at a large asset management firm, WealthBuild Capital Partners (WBCP). He is developing and maintaining custom portfolios to meet the needs of the firm's clients, which consist of both ultra-high-net-worth (UHNW) and institutional investors.

Garza is reviewing the income-generating ability of a portfolio that includes public fixed income and private debt for a UHNW client, Cheung Lee. The current economic environment is characterized by a slowing economy and low interest rates. However, Garza believes that as the economy begins to recover next year, the central bank will raise interest rates to stave off inflation. He expects equity returns to be muted in response to this environment. He wants to position the portfolio to be able to take advantage of the potentially higher interest rates while also being cautious due to current economic developments.

At lunch, Garza speaks to the firm's economist, Shang Dian, about the current market and lagging economy. Dian notes that credit has been less available due to the deteriorating economy, which has resulted in increased competition among lenders in high quality, recession-resistant businesses. Transaction activity has slowed significantly, existing loans are being amended, and maturities are being extended. Garza ponders what this means for the types of transactions he should target.

Later that day, Garza is working with an insurance company client, Ding Hao Life Insurance (DHLI). DHLI is considering allocating a portion of its portfolio to private debt. The company is conservative and prioritizes investments that offer steady income with minimal volatility. As a secondary consideration, DHLI is concerned about liquidity and risk. Garza considers several investment vehicles available on WBCP's platform to assess whether any of them would allow DHLI to access private debt efficiently.

That evening, Garza receives an email from a large institutional client, Zian Yazhu of ZY Foundation, who is concerned about the structuring of various debt deals her foundation is investing in. Yazhu specifically wants to ensure that the foundation always maintains a senior claim on the underlying company's operating assets, regardless of the type of debt involved. Yazhu is less familiar with different types of subordination and asks Garza about the best way to ensure the foundation maintains a senior claim, particularly when considering more complex debt structures. Garza evaluates the best options for Yazhu to meet this goal.

Question 2.1

Based on current economic conditions and Garza's contrarian view, which of the following types of debt is *most appropriate* for Lee's portfolio?

A. High-yield bonds

B. Leveraged loans ✓

C. Convertible bonds

Explanation:

Private debt loan types		
Debt type	**Description**	**Key features**
Leveraged loans	Floating-rate loans tied to a market reference rate plus a spread	Income rises with rates; senior secured
High-yield bonds	Fixed-rate bonds from sub-investment grade issuers	Vulnerable to rising rates and credit deterioration; higher default risk
Convertible bonds	Hybrid debt with embedded option to convert to equity	Equity upside; sensitive to stock performance

Leveraged loans are **floating** interest rate loans that reset periodically based on a market reference rate plus a credit spread. The **income** generated by these loans **increases** as **interest rates rise**, which aligns with Garza's outlook. In addition, leveraged loans are **senior secured**, offering collateral security and providing a level of credit protection compared with unsecured debt.

In this scenario, leveraged loans are most appropriate since they **generate income** and their characteristics **balance the default risk** in a **slower economy** with the contrarian view of interest rates rising in the near-term.

(Choice A) High-yield bonds are vulnerable to a rising rate environment due to their fixed coupons. In addition, the slowing and uncertain economic picture could result in widening credit spreads or increasing defaults, both of which would impact the value of these bonds.

(Choice C) Although convertible bonds offer potential equity upside, they are not designed to capitalize on rising interest rates. Their hybrid nature makes them sensitive to equity market performance rather than to interest rates.

Things to remember:
Leveraged loans have floating rates that make them more resilient in a rising rate environment. High-yield bonds have fixed rates less suitable for a rising rate

environment, and they are more exposed to widening credit spreads or defaults. Convertible bonds offer equity upside but are tied to equity market performance.

Question 2.2

Assuming the credit environment described by Dian, the type of loans Garza should *most likely* target are:

A. sponsored.

B. covenant-lite.

C. nonsponsored. ✓

Explanation:

Sponsored vs. nonsponsored loans		
Loan type	**Description**	**Key features**
Sponsored	• Loans backed by private equity sponsors	• More aggressive financial structures, often used for leveraged buyouts
Nonsponsored	• Loans made directly to companies without private equity backing, often to original founders	• Less aggressive, granted to financially strong companies • Higher credit quality and more attractive during economic downturns
Covenant-lite	• Loans with fewer (or more flexible) covenants or lender protections	• Offer greater flexibility to borrowers but pose more risk to lenders, commonly seen in sponsored loans

In a **slowing economy** with **reduced credit** availability, lenders are likely to target **high-quality**, recession-resistant businesses. Dian notes **increased competition** among lenders, which **implies tighter pricing** in **sponsored** loans, where private equity sponsors back the borrower. In contrast, **nonsponsored** loans are extended **directly** to **companies** without private equity involvement, typically to an original founder or ownership group seeking outside capital for the first time.

Nonsponsored loans generally involve **less aggressive** financial structures and are more likely extended to **financially strong companies** that can navigate uncertain economic conditions without the need for additional equity support. For lenders, nonsponsored loans **offer greater credit quality** as they are typically extended to companies with strong credit profiles, making them attractive during periods of economic uncertainty.

(Choice A) Sponsored loans are typically associated with private equity–backed firms. In an environment where credit is constrained, there is more competition for sponsored loans to high-quality companies, driving down spreads and limiting the loans' appeal.

(Choice B) A covenant-lite loan includes fewer covenants, which are credit enhancements for the lender. These loans are less common in an environment with tightening credit conditions, as lenders tend to require more covenants.

Things to remember:
Sponsored loans are backed by private equity sponsors and often involve aggressive financial structures, while nonsponsored loans are made directly to companies without private equity involvement. Covenant-lite loans, which are more common in sponsored deals, offer fewer lender protections and give borrowers greater flexibility.

Question 2.3

Which of the following is *least appropriate* for Garza to recommend to DHLI?

A. Mezzanine debt ✓

B. Direct lending funds

C. Collateralized loan obligations (CLOs)

Explanation:

Types of debt		
Debt type	**Description**	**Key features**
Direct lending funds	Loans to middle-market companies	Suitable for conservative investors, offering higher yields
Collateralized loan obligations	Structured products pooling leveraged loans	Diversified exposure with varying risk-return profiles
Mezzanine debt	Subordinated debt with equity-like features	Higher risk and volatility, less suitable for conservative investors

Mezzanine debt is typically **subordinated** and often includes **equity-like features**, such as warrants or conversion rights, which may introduce **greater volatility** and **risk**. For a conservative client like DHLI, mezzanine debt may not align with its focus on steady income and minimal volatility. Direct lending funds and collateralized loan obligations (CLOs) offer more predictable and stable income streams, making them more suitable for DHLI's portfolio.

(Choice B) Many direct lending funds provide private loans to middle-market companies, typically offering a higher return. These funds are appropriate for conservative investors seeking private debt exposure.

(Choice C) CLOs pool leveraged loans into a special purpose vehicle, which then re-issues them separated into prioritized liability tranches with varying risk levels. This structure offers conservative investors diversified exposure to private debt markets, making CLOs an appropriate option for DHLI.

Things to remember:
Mezzanine debt often includes subordinated claims and equity-like features, making it riskier than other forms of private debt. Direct lending funds and collateralized loan obligations typically offer more predictable returns and better align with conservative investment goals.

Question 2.4

Yazhu's focus on ZY Foundation maintaining a senior claim would be *least likely* accomplished by investing in private debt with:

A. structural subordination. ✓

B. contractual subordination.

C. an intercreditor agreement.

Explanation:

Subordination in private debt		
Debt structuring	**Description**	**Key feature**
Structural subordination	Debt issued at holding company level subordinated to parent company organization's debt	HoldCo lender only has equity claim on equity, not the operating assets, of OpCo, and thus its claims are subordinate to OpCo's creditors' claims
Contractual subordination	Senior and subordinated lenders agree on claim priority	Specifies lender priority on operating assets in the event of default or liquidation
Intercreditor agreement	Contract defining relative priority among lenders	Clarifies lender rights in complex debt structures in the event of default or liquidation
HoldCo = Holding company, OpCo = Operating company		

Structural subordination occurs when debt is **issued** by a **holding company** (HoldCo), leaving it **one step removed** from the operating company (OpCo) and its assets. Since the HoldCo creditors have a claim only on the **equity** in the **OpCo** rather than on its operating assets, they are **subordinated** to the creditors of the OpCo, who have direct claims on its assets. Therefore, structural subordination **does not ensure** a senior claim on the operating assets, making it the least appropriate option for the client's objective.

(Choice B) In contractual subordination, an agreement (eg, an intercreditor agreement) is executed between lenders to clearly specify the priority of claims on the company's operating assets. This structure allows for explicit contractual arrangements to ensure that the lender maintains a senior claim on the company's assets.

(Choice C) An intercreditor agreement specifies the priority of claims among different lenders, which ensures that the lender can maintain its senior claim on the company's assets. Such agreements are common in complex debt structures.

Things to remember:
Structural subordination leaves creditors one step removed from a company's operating assets and typically grants them only an equity claim on assets, making it the least effective type of private debt for securing a senior claim. Contractual subordination and intercreditor agreements can ensure that creditors maintain senior claims on company assets.

Apex Capital Partners (ACP)

Apex Capital Partners (ACP), a middle-market direct lending firm based in the US, offers comprehensive capital structure solutions for financial sponsors focused on technology companies. Teuna Liselot, CFA, an origination vice president on temporary assignment from the Amsterdam office, must train a new associate, Gustavo Terance.

Liselot asks Terance to tell her what he knows about private direct lending. Terance, who has experience exclusively with high-yield bonds, states:

Statement 1: Mezzanine debt typically has a shorter tenor to limit the period during which lenders receive paid-in-kind interest.

Statement 2: Intercreditor agreements define the actions lenders can take in the event of a borrower defaulting on its debt.

Statement 3: When a borrower's capital structure includes both senior secured and mezzanine debt, structural subordination is typically applied.

Later, Liselot gathers financial data projections from a sponsor's budget on a deal she is currently underwriting to finance the buyout of PMM LLC. She asks Terance to compile and review credit ratios based on the sponsor's three scenarios.

Exhibit 1 PMM LLC Scenario Analysis

	Revenue	EBITDA	Gross Debt	Retained Cash Flow	Interest Expense	Cash
TTM actual	18,252	2,282	9,128	1,415	652	800
Scenario 1	18,570	2,600	7,800	1,378	546	350
Scenario 2	19,688	2,559	8,189	1,346	640	500
Scenario 3	17,642	2,646	7,409	1,386	529	300

TTM = trailing twelve months

After discussions with client sales reps, Liselot learns that the demand for the underwriting from ACP's co-investors is not strong and she must consider modifications to the loan to make it more appealing. Due to internal risk limits, ACP must syndicate any amount above its maximum hold limit, which is 40% of any loan tranche.

Liselot is assigned another deal to underwrite but notices that it is unlike most ACP transactions. Based on the marketing materials, the prospective borrower has no financial sponsorship. A wealthy entrepreneur is bringing the deal to several middle-market lenders as a one-time investment using her own equity capital.

Question 3.1

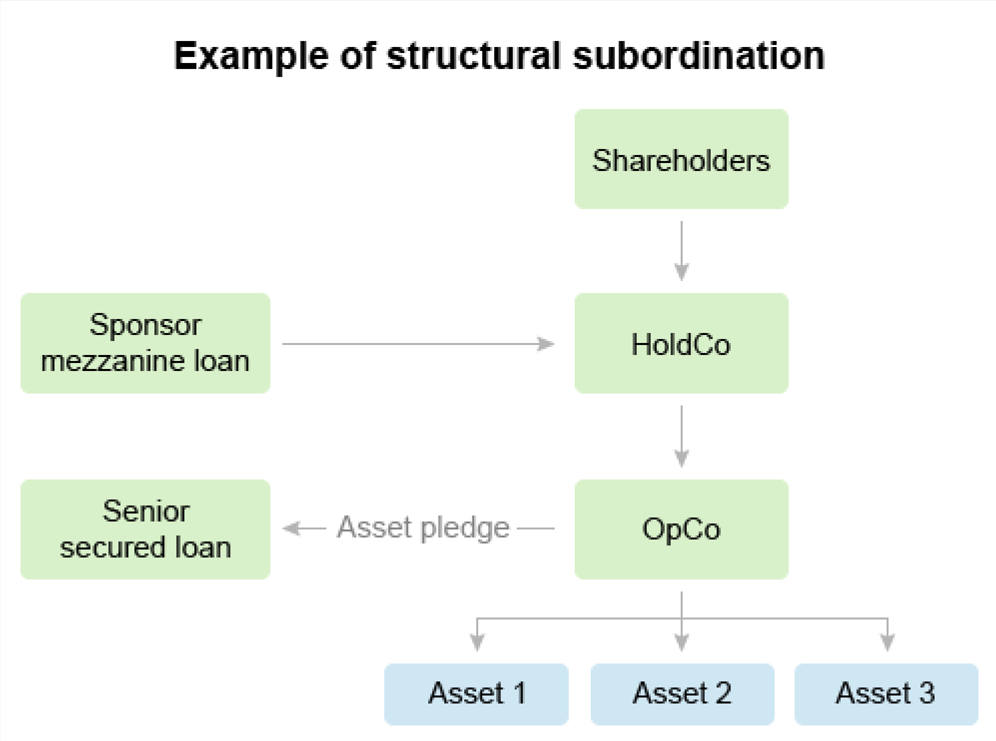
Which of Terance's statements is *most likely* correct?

A. Statement 1

B. Statement 2

C. Statement 3 ✓

Explanation:



Debt subordination refers to a **lower priority** or rank in terms of **claims** or rights to **cash flow** and **assets**. Structural subordination occurs when a lender's claims on a borrower's assets are subordinated due to the borrower's organizational structure. This typically happens when debt is issued at different levels within a corporate group.

Parent (HoldCo) **creditors** are typically **structurally subordinated** to **subsidiary** (OpCo) creditors, who have direct claims on the subsidiary's assets. In the event of a default or liquidation, OpCo creditors are paid first, and if the OpCo creditors' assets are insufficient to repay their debt in full, the HoldCo creditors may receive no recovery.

(Choice A) Statement 1 is incorrect. Mezzanine debt typically has a longer tenor to match the long-term financing needs of companies, such as in leveraged buyouts or growth scenarios. This extended tenor provides borrowers with greater flexibility and supports cash flow during growth or restructuring.

(Choice B) Statement 2 is incorrect since an intercreditor agreement outlines the rights, responsibilities, and priorities of multiple lenders or creditors involved in a borrower's capital structure. It is typically used in cases where a borrower has both senior and subordinated debt secured by the same package of collateral.

Things to remember:
Structural subordination occurs when a lender's claims on a borrower's assets are ranked lower due to the borrower's organizational structure. This usually happens when debt is issued at different levels within a corporate group, such as at the parent company (HoldCo) and one or more subsidiaries (OpCo).

Question 3.2

The *most appropriate* modification to the terms of a syndicated leverage loan offering with low demand would be to:

A. renegotiate the covenants.

B. increase the discount margin. ✓

C. tie interest margin to leverage tiers.

Explanation:

Leveraged loan quoted margin (QM) vs. discount margin (DM)		
Loan price at	**QM vs. DM**	**Yield**
Discount (< par)	QM < DM	Increases
Par (= 100% face)	QM = DM	= MRR plus spread
Premium (> par)	QM > DM	Decreases

Leveraged loans generally have a **floating interest rate** based on a periodically reset MRR (eg, SOFR) plus a fixed margin for credit risk. The **loan's discount margin** (DM) **relative** to its **quoted margin** (QM) is crucial for determining a stressed/distressed loan's yield at origination and its MRR reset, as well as for secondary market trading. Loans are rarely issued at par due to conventional QM increments (eg, 25 basis points), making par value rare.

If the market demands a DM higher (lower) than the QM, the loan's price must be adjusted downward (upward) to match the required yield. For example, if the market demands a yield of SOFR plus 400 basis points on a loan with a SOFR plus 350 QM, the loan will be priced below par, enabling lenders to earn the 350-basis-point QM plus additional yield from the discount accruing to par.

(Choice A) Renegotiating the covenants may make the below-market yield more palatable to investors if they benefit from tighter covenants and more control. This process is often costly and time-consuming since documents must be modified, and lawyers and bankers must spend time negotiating with the borrower and prospective lenders.

(Choice C) Similar to covenant renegotiation, tying the interest margin to leverage tiers often reduces future credit risk mispricing. This process can also be costly and time-consuming as documents must be modified, and lawyers and bankers must spend time negotiating with the borrower and prospective lenders.

Things to remember:
The discount margin as compared to the quoted margin is crucial for determining a stressed/distressed loan's yield at origination and its MRR reset, as well as for trading in the secondary market. Targeting a required discount margin frequently leads to

discounting of the price to make the below-market quoted margin meet the yield demanded by the market.

Question 3.3

Based on Exhibit 1, in which scenario would PMM LLC *most likely* receive a credit rating upgrade?

A. Scenario 1

B. Scenario 2

C. Scenario 3 ✓

Explanation:

PMM LLC key financial ratios					
	Revenue growth	EBITDA margin	Total leverage	Retained cash flow	Interest coverage
TTM actual	NA	12.5%	4.0x	17.0%	3.5x
Scenario 1	1.7%	14.0%	3.0x	18.5%	4.8x
Scenario 2	7.9%	13.0%	3.2x	17.5%	4.0x
Scenario 3	−3.3%	15.0%	2.8x	19.5%	5.0x
TTM = trailing twelve months					

Private credit rating agencies, such as Moody's and S&P Global, assess the creditworthiness of corporations and other public or private entities and assign credit ratings based on the borrower's ability to repay debt and the likelihood of default. These ratings impact borrowing costs, access to capital, market perception, and risk management.

Corporate creditworthiness is **evaluated** through **both qualitative** factors, such as business model, industry, size, and competitive position, and **quantitative** factors, such as profitability, debt coverage, and financial leverage. Agencies use a rating system to analyze financial ratios, industry benchmarks, and qualitative factors to determine credit ratings.

In Scenario 3, PPM LLC demonstrates the most favorable improvement in quantitative credit risk factors compared to its TTM actual results. Despite projected negative revenue growth, Scenario 3 benefits from expanding EBITDA margins, leading to lower leverage, more retained cash flow as a percentage of net debt, and an improved interest coverage ratio.

(Choices A and B) While these scenarios both show general improvement of financial ratios when compared to the last twelve months, Scenario 3 exhibits the most improvement.

Things to remember:
Credit rating agencies assess a borrower's corporate creditworthiness using both qualitative factors, such as business model, industry, size, and competitive position, and quantitative factors, typically represented as financial ratios.

Question 3.4

Compared to public debt markets, which of the following *best describes* a distinctive risk of private debt markets?

A. The lack of a sponsor ✓

B. Structural subordination

C. The need to hold loans to maturity

Explanation:

Key sources of private market debt risk and return	
Risk	**Description**
Credit risk	Changes to spreads are tied to the illiquid investment life cycle of the underlying company.
Interest rate risk	Lower due to prevalence of floating interest rates.
Liquidity risk	Private equity-like fund structures accommodate higher liquidity risk.
Inflation risk	Floating interest rates are attractive to institutions with inflation-adjusted liabilities.
Borrower and lender contingencies	Embedded equity claims benefit lenders, while prepayment and fixed call options benefit borrowers.
Direct lending features	Informational opaqueness adds challenges when sourcing, analyzing, and structuring private loans.

Private debt markets involve **direct lending** to borrowers by private investors or institutions, bypassing public debt markets. This financing method has gained appeal due to its greater return potential compared to public debt, despite risks like low liquidity and reduced transparency.

Key risks in private debt markets often mirror those in public debt markets but are magnified. Specific risks associated with lending to a borrower with no financial sponsor include:

- Informational: Increased credit risk due to lack of rigorous financial scrutiny, reduced market presence, and challenges in monitoring
- Managerial: Lack of oversight, absence of exit strategies, less effective risk management, weaker corporate governance, and higher risk of management turnover
- Operational: Limited resources and operational weaknesses

(Choice B) While structural subordination is common in private loans, it is also prevalent in public debt markets where different classes of debt (eg, secured bank loans and high-yield bonds) exist at various corporate levels.

(Choice C) The liquidity constraints and absence of secondary markets in private debt often require that loans be held to maturity. Similar issues can occur in public markets, although they are often less pronounced due to better liquidity and more frequent refinancing opportunities.

Things to remember:
Risks in private debt markets often mirror those in public debt markets but are intensified. Lending to companies without a financial sponsor introduces unique risks to lenders.